Canadian Financial Institutions: Changing the Regulatory Environment

The Falculty of Law-University of Toronto
Institute for Policy Analysis-University of Toronto
Canadian Bar Association-Ontario
Ontario Economic Council

Edited by
Jacob Ziegel
Leonard Waverman
David W. Conklin

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Special Research Report

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Canadian Bar Association - Ontario
Ontario Economic Council

81 Wellesley Street East
Toronto, Ontario
M4Y 1H6

Printed in Canada

Canadian Cataloguing in Publication Data

Main entry under title:

Canadian financial institutions

(Special research report/Ontario Economic Council,
ISSN 0225-591X)
ISBN 0-7729-0956-3

1. Financial institutions – Law and legislation – Canada – Congresses.
I. Ziegel, Jacob S. II. Waverman, Leonard, 1941- .
III. Conklin, David W. IV. Ontario Economic Council.
V. Series: Special research report (Ontario Economic Council)
HG185.C3C36 1985 354.710082'5043 C86-099605-0

This report, printed after the Ontario Economic Council was disbanded in late 1985, reflects the views of the authors and not necessarily those of the Council or the Ontario government. The Council established policy questions to be investigated and commissioned research projects, but it did not influence the conclusions or recommendations of authors. The decision to sponsor publication of these papers was based on their competence and relevance to public policy.

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Foreword

This book grew out of a conference entitled The Changing Regulatory Environment for Canadian Financial Institutions held 22-23 May 1985 at the Sutton Place Hotel, Toronto, Ontario. Sponsored by the faculty of law and the Institute for Policy Analysis at the University of Toronto, the Canadian Bar Association, and the Ontario Economic Council, the conference's aim was to bring together members of the academic, legal, policy-making, and business communities to analyse and discuss the major issues surrounding the regulation of financial institutions in Canada.

The editors believe the resulting collection of studies to be a valuable and timely contribution to the public debate on the appropriate operation and future structure of Canadian financial institutions. We would like to express our appreciation to the individuals who particiated in the conference and the preparation of this volume. Staff of the Ontario Economic Council deserves special credit: Administrative Officer Sharon Wahl; Publications Officer Brenda Huff; Style-editor John Southerst; Proofreader James Leahy; Word Processing Technicians Tom Gerylo, Sylvia Machek, and Holly Micallef; Publications Assistant Kathy Ashenden; Librarian Louise Ayotte-Zaretski; and Research Officers Alex Athanassakos, Kevin Dowd, Jacob Levenstein, and Ardeshir Noordeh. Special thanks are also extended to freelance style-editor John Parry.

CANADIAN FINANCIAL INSTITUTIONS: CHANGING THE REGULATORY ENVIRONMENT

PART I: OVERVIEW

Regulating the Canadian financial system: paradigms, principles, and politics

Thomas J. Courchene

I INTRODUCTION

The purpose of this paper is to survey both the jurisdictional and the policy issues in regulating the Canadian financial services sector. Part II presents some analytical and definitional background relating to the rationale for financial intermediation. Part III touches briefly on the rationale for regulating the financial sector, drawing the distinction between policing regulation and planning regulation. Part IV presents three competing financial models – a capital-markets- based prototype, typical of the United States; the state-dominated, credit-based system characteristic of France and Japan; and a bank-dominated, credit-based system of the West German type. The analysis of these alternative approaches takes on added interest because it provides a framework for viewing some of the recent Canadian proposals for reform of the financial sector.

Part V presents a brief overview of the Canadian financial system and lays the background for the analysis of deposit-taking institutions (Part VI) and the securities industry (Part VII). In addressing both financial and market intermediaries the focus is, in turn, on the jurisdictional aspects of the regulatory framework, on the policy issues that loom large in each of these areas, and on the recent official reports or proposals for reform. In terms of official documents, emphasis is directed to the recent federal government paper *The Regulation of Canadian Financial Institutions*, henceforth referred to as the

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Green Paper, and to the recent Ontario Securities Commission (OSC) report, *A Regulatory Framework for Entry into and Ownership of the Ontario Securities Industry.*[1] Part VIII summarizes the thrust of the paper.

Ideally, a background paper should attempt to present all sides of the range of issues that are addressed. I doubt that I have succeeded in doing this. Hence, the paper is best viewed as a personal or interpretative survey of the jurisdictional and policy issues related to the Canadian financial sector.

II THE RATIONALE FOR INTERMEDIATION

Following Gurley and Shaw (1960), one can approach the role of intermediation by focusing initially on economic 'spending units', i.e., those economic units whose principal function 'is to produce and purchase output and not to buy one type of security by issue of another' (p. 93). At any given time some spending units will have surpluses (the ultimate lenders) and some will have deficits (the ultimate borrowers). The role of the financial system is to intermediate between these ultimate borrowers and lenders 'to collect the surpluses of the surplus spending units and make them available to the deficit spending units' (Shearer, Chant, and Bond 1984, p. 7).

To carry this analysis further, consider two polar types of securities – primary securities and indirect securities. The former would include all debt and equity issues of non-financial spending units. For example, corporate equities, corporate bonds, accounts payable, consumer debt, mortgages, and government debt would all qualify as primary securities. Indirect securities are defined as the issues of financial institutions. Corresponding to these two general types of securities are two general methods of financing. Direct finance results in primary securities ending up in the portfolios of surplus spending units. Indirect finance, or intermediated finance, or financial intermediation results in indirect securities ending up in the portfolios of surplus spending units. Thus the process of financial intermediation is one of a financial institution purchasing primary securities from ultimate borrowers and issuing indirect securities for the portfolios of the ultimate lenders.

The role of the financial sector is to facilitate this transfer of funds between borrowers and lenders, i.e., to facilitate both direct and indirect finance. In terms of the former, the principal actors in

generating efficient primary and secondary markets are the brokers, dealers, and underwriters, collectively referred to as the securities industry or sometimes as market intermediaries (JSIC, 1984). The institutions that facilitate the process of indirect finance are generally referred to as financial intermediaries. Frequently one distinguishes between monetary financial intermediaries (the banking sector) and non-monetary financial intermediaries (the near-banks, such as trust companies, credit unions, and insurance companies).

Essentially, financial intermediaries are in the business of transforming financial assets. In terms of the variety of ways that financial assets can be transformed, the following, adapted from Shearer, Chant, and Bond (1984, pp. 181-3), are probably the most important:

1 payments intermediation, which results from a financial intermediary holding a collection of assets that do not serve as a means of payment but then issuing claims on itself that can be so used.
2 maturity-risk intermediation, which relates to the transformation of assets such that the intermediary supplies funds the terms of which are not matched by its source of funds. Shearer, Chant, and Bond identify three different forms:
   i) term intermediation, which results in a financial institution supplying funds for a different term, normally longer, than that for which the funds have been borrowed.
   ii) capital value intermediation, which results when a financial intermediary lends (borrows) at fixed rates even though the interest paid on the funds it borrows (lends) is not fixed.
   iii) denomination intermediation, which results in financial intermediation supplying funds to borrowers in different denominations from the sources of funds.

This resort to first principles explains both too much and too little. The financial sector is immensely more complicated than this stylized version. And the system is not as compartmentalized as the above analysis suggests. For example, the distinction between monetary and non-monetary financial intermediaries has become increasingly blurred in recent years: both types of institutions are involved in the process of generating 'means of payment.' Likewise, financial intermediaries are becoming involved in the market-intermediation

function (e.g., the T-D Bank's Green-Line Investor Service), and market intermediaries are now involved in supplying indirect securities (Merrill Lynch's Cash Management Account).

Nonetheless, the analysis serves to highlight two features of the financial sector that will be important to the remainder of the analysis. First, there is an important difference in the roles played by market intermediaries and by financial intermediaries. This difference exists in practice in the financial systems of Canada, the United Kingdom, and the United States. But it is less important in other financial systems (e.g., those of France, West Germany, and Japan). Part IV of this overview focuses in some detail on this issue.

Second, the nature of the analysis indicates that the role of the financial sector is to contribute to overall resource allocation – to ensure that savings are directed to their most productive uses. In turn, this suggests that the financial sector might well be evaluated not in terms of any intrinsic characteristics but rather in terms of the manner in which it serves the larger objective of efficient resource allocation. Shaw and Archibald (1977) suggest that there are two aspects to this efficiency:

> The capital market system must be both *allocationally efficient*, that is, funds are directed to the right projects, and *operationally efficient*, that is, the necessary services are provided at minimum cost. (p. 18)

This emphasis on efficiency will be important throughout the paper since the current pressures for regulatory reform arise as much from such things as the mushrooming of technology and the increasing globalization of world markets as from such factors as consumer protection and the prevention of fraud.

Now that we have broached the issue of financial regulation, it is appropriate to focus on the various rationales for regulation.

III THE REGULATORY RATIONALE

In terms of the range of goals served by the regulation of financial intermediaries, the Economic Council of Canada's summary (1976) is helpful:

> The existing regulations governing deposit institutions in Canada have been justified on the grounds that they protect depositors, assist in the workings of monetary policy, encourage competition and efficiency in financial markets, influence the composition of economic activity, preserve the separation of financial and non-financial activities and foster the Canadian ownership of the financial sector. (p. 49)

In terms of the role for regulation in capital markets (the securities industry or market intermediaries), the federal deputy minister of finance, Mickey Cohen, noted recently that the policy or regulatory concerns are five-fold – solvency, competition, efficiency, conflicts of interest, and concentration (1983, p. 6). To these one can add those concerns that represent overall public policy goals. For example, from the recent OSC report on entry and ownership of the Ontario securities industry (1985):

> The Commission determined that there are basically two overriding (Ontario) public policy objectives which must be preserved, that is to say:
>
> 1. it recognizes the Government's policy that ownership of securities firms must remain substantially Canadian; and
> 2. it recognizes that as a matter of public policy the financial system should be organized into 'four pillars', with each group of participants in the financial system, i.e., banks, trust companies, insurance companies and securities firms, providing distinct services. (p.ii)

The first set of concerns has led to such regulatory initiatives as registration, capital requirements, and, of course, ownership restrictions; the second has led to policies such as institutional separation and restrictions on financial-sector cross-ownership.

More generally, one might, following Schultz and Alexandroff (1985), conceive of regulation as falling into a 'policing' and a 'planning' role:

> Policing regulation . . . is employed to pursue a fairly narrow, circumscribed set of policy objectives that are primarily

> internal or endogenous to the industry regulated. By the latter point we mean that regulation policy objectives in a policing regime are usually confined to those involving the most immediate participants, the firms and their customers. Planning regulation, however, is employed to attain a much broader, more comprehensive set of goals, including, and possibly primarily, exogenous objectives. Such objectives involve the use of the sector . . . for goals external to the main participants. An example would be regulation of railroads to promote regional development; another would involve regulating telecommunications for national unity objectives. Our argument [is] that policing regulation endows corporate executives with the greatest degree of autonomy to make the central decisions affecting their firms whereas in planning regulation, corporate autonomy is significantly diminished as government emerges as the primary goal setter not only for the firms but the industry or sector of economic activity. (Chapter 5)

In the securities area, the recent disallowance of Gordon Capital's proposal for a joint venture with Brussels Lambert would clearly qualify as planning regulation.

There will always be a trade-off between the various regulatory goals – even within the policing function, policies geared to investor protection (e.g., deposit insurance) may be at odds with enhancing institutional solvency, as will be elaborated later. However, the greater conflicts are likely to be between the policing and planning functions of regulation. At a time when regulators appear to be placing more emphasis on planning relative to policing, the pressures for change in the financial sector are, as noted in the previous section, arising from factors such as the computerization and the globalization of markets, which generate intense competition within the industry, and, in turn, frequently run into direct conflict with the 'planning' aspects of financial regulation, which tend to view the sector within some broader socio-economic framework.

These concerns come to the fore in the current domestic and international economic environment where the emphasis is on industrial adjustment and where the financial sector must surely be assumed to be one of the key players in the adjustment process. However, it is instructive to look at the interaction between economic adjustment and the financial sector. In a recent book, *Government, Markets and Growth* (1983), political scientist John Zysman presents a global

overview of the interaction between financial systems and economic adjustment that has relevance to both of the previous perspectives, namely the distinction between financial and market intermediaries on the one hand and the relation between the policing and planning functions of regulation on the other hand.

IV FINANCE AND ADJUSTMENT: COMPETING PARADIGMS

Zysman's thesis is that the nature of a country's financial markets is a critical factor not only in the manner in which business and government interact but also of the process of economic adjustment and/or restructuring. Specifically, he describes and evaluates three prototypes of financial systems:

1 a capital-markets, competitive-pricing prototype, in which the longer-term source of corporate finance is supplied competitively by the capital markets. The United States conforms to this model.
2 a state-dominated, credit-based financial system, in which the longer-term sources of corporate finance tend to take the form of credit rather than equity and in which both the price and allocation of capital are monitored closely by the state. France and Japan are his examples.
3 a bank-dominated, credit-based financial system. West Germany is the obvious example.

These prototypes are summarized in Table 1.

Zysman's conception of the role of financial systems lends perspective to several issues relating to the regulation of the Canadian financial sector. First, there is a substantial difference in the nature of financial instruments in market-based and credit-based systems. In particular, in market-based systems the longer-term financing of the corporate sector is generally accomplished through capital markets. In credit-based systems, financing of the business sector takes place largely through loan markets. This is evident from Table 2, which compares France and the United States: bonds and equities play a much longer role in industrial financing in the United States than in France, and the reverse is the case for loan finance.

Second, there are equally significant differences in the structure of the financial sectors. Typically under credit-based systems, financial intermediaries are also very active as 'market intermediaries', or,

TABLE 1
Financial systems and industrial adjustments

	Type of financial system	Model of the adjustment process	Country examples
1	Capital market with competitive prices	company-led	United States
2	Credit-based, with administered prices	state-led	Japan, France
3	Credit-based, with price formation dominated by banks	negotiated	West Germany

SOURCE: Zysman (1983), Tables 6.1 and 6.2.

more correctly, as providers of long-term corporate finance. The power of the West German 'universal' banks, which not only dominate the sources of finance for industry but also are able to own substantial stock in corporations, probably represents an extreme case. Nonetheless, this situation is in stark contrast to the Canadian (or Ontario) situation where the regulatory emphasis is not only on the maintenance of 'four pillars' but also on the separation of ownership. Hence, while it is obviously possible to make a case for a financial system that attempts to view the securities market as a 'separate' pillar, such an arrangement is not characteristic of financial systems in some other countries. More intriguing still, in this context, is the fact that the recent federal proposals on financial regulation represent an abrupt shift in direction – a change that, via the holding-company route, would move Canada toward the West German model, including the co-mingling of the real or commercial and the financial sectors. More on this later.

Third, and perhaps most important, the nature of the financial sector greatly affects the economic adjustment process and government's role within this process. In the capital-based model, where prices are determined in competitive markets, economic adjustment is essentially company-led. This is in stark contrast to the situation in the state-dominated, credit-based systems, where

TABLE 2
Credit-based and capital-market-based financial systems: France and the United States (1975)

Country	Securities markets as a percentage of GNP		Share of corporate finances with long-term credit institutions	
	Bonds	Equity	Deposits	Loans
France	16	11	8.2	32.9
United States	57	45	5.5	7.9

SOURCE: Zysman (1983), Table 2.1.

> credit extended by institutions becomes a linchpin in the system of industrial finance and government is drawn in to bolster the system and to make administrative choices about allocation . . . The borderline between public and private blurs, not simply because of political arrangements, but because of the very structure of financial markets. (pp. 72-3)

Hence, adjustment there is said to be state-led. In the third category, also a credit-based system, a limited number of financial institutions dominate the system without themselves being dependent on state assistance:

> Government does not have the apparatus to dictate allocative choices to the financial institutions and consequently it has no independent instruments in the financial system within which to influence companies. Banks, however, can serve as policy allies for government on terms negotiated between government and finance. (p. 72)

Zysman labels the adjustment process there a negotiated one.

Thus, government's function in adjustment will depend in part on the nature of the financial system:

> The government can be an economic regulator, an economic administrator, or an economic player. As a *regulator*, it is an umpire refereeing the behavior of others in the hope that if they follow a particular set of rules, a certain set of outcomes will occur. Controls on mergers and on securities issues are examples of such rules. As an *administrator*, the government executes certain operations based on a specific assignment or task, applying particular decision criteria and following set procedures. As a *player*, it pursues specific outcomes on a case-by-case basis, assembling packages of incentives which can be used to persuade or coerce. It discriminates among firms and applies administrative rules and regulations to accomplish particular objectives. (p. 75)

What has all this to do with the Canadian financial system and its regulatory overlap? First, despite the recent recession that forced many firms into the banks, Canada's financial system (in terms of long-range industrial finance) is essentially a capital-markets-based system. In this sense we are like the Americans. Second, and here we are unlike the Americans at least in degree if not in substance,[2] there is a tendency for the Canadian state to be more involved in economic adjustment. But since our financial system is not conducive to state-led adjustment, this tendency may have motivated the proliferation of government activities in the financial sector. Several provinces have established venture capital programs and small-business development corporations. At the federal level there exist agencies or Crown corporations such as the Farm Credit Corporation, the Federal Business Development Bank, and the Canadian Development Investment Corporation, let alone the series of high-profile bailouts and the operations of the various agencies coming under DREE and/or DRIE.

Nonetheless, these ancillary ventures do not really offset the underlying capital-based orientation of Canadian capital markets. This poses a basic quandary for Canadians and for our approach to the capital markets. Given our willingness (relative to the United States) to look benignly at government and its intervention, one obvious option is to reshape our financial sector to make it more consistent with a state-led approach to economic adjustment. This would entail a fundamental restructuring of the financial system and in my view is a non-starter.

The preferred alternative is to move to strengthen substantially the role of the securities industry within the present structure and, therefore, to provide an adequate framework within which adjustment can be company-led. The status quo represents an uneasy and perhaps unsustainable compromise, since the capitalization of the Canadian securities industry is, again in my view, inadequate to facilitate company-led adjustment (Courchene, 1984).

Second, the Canadian financial system poses a further quandary with respect to the Zysman scheme. Suppose that the federal government did want to move in the direction of a state-led approach to industrial adjustment. The fact that the regulation of market intermediaries is under provincial jurisdiction would complicate substantially any such strategy. Later in the paper I shall defend, within certain limits, the status quo in this regard. However, it is important to recognize that the Government of Canada's recent Green Paper (1985) on financial regulation can be viewed as an attempt, albeit indirect, to bring market intermediaries within the federal sphere of regulatory influence.

Third, and related, Zysman's conception of the role of financial systems lends perspective to some of the issues currently facing the Canadian regulators. Domestically, the Canadian (or Ontario) approach has been to beatify the four-pillar concept. This is evident from Table 3, where Ys (denoting yes) for commercial lending, estate administration, underwriting, and insurance (the four pillars) appear respectively in the columns for banks, trust companies, securities dealers, and insurance companies. What this means, for example, is that, within Canada, the chartered banks are prevented from undertaking an underwriting role either directly or via ownership of securities firms. The prohibitions on this score relate to provisions in the Bank Act as well as to ownership restrictions imposed on registered securities dealers. However, outside Canada, the banks may do as they please. And they are beginning to act, internationally, very much like merchant or universal banks. Orion and CIBC (London), which are subsidiaries, respectively, of the Royal Bank and the CIBC, are becoming major players in the placing of Canadian offshore equity issues. With the increasing globalization of capital markets, the distinction between domestic and international regulation is becoming progressively more artificial and difficult to maintain, and

TABLE 3

Products and Services Offered by Financial Institutions

FINANCIAL INSTITUTIONS / PRODUCTS AND SERVICES	Credit Unions	Securities Dealers	Provincial Insurance Companies	Federal Insurance Companies	Proposed Canada Savings Banks & Trust Companies Act	Provincial Loan Corporations	Federal Loan Companies	Provincial Trust Companies	Federal Trust Companies	Banks
Deposit Taking	Y	Y	N	N	Y	Y	Y	Y	Y	Y
Chequing Accounts	Y	L	N	N	Y	Y	Y	Y	Y	Y
Commercial Lending	L	N	N	N	L	L	L	L	L	Y
Mortgage on Real Property	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Safety Deposit Boxes	Y	Y	N	N	Y	Y	Y	Y	Y	Y
Safekeeping of Property	Y	Y	N	N	Y	Y	Y	Y	Y	Y
Guaranteed Investment Certificates	N	N	N	N	Y	N	N	Y	Y	N
RRSPs and RHOSPs	Y	L	Y N	Y N	Y	Y	Y	Y	Y	Y
Estate Administration	N	N	N	N	Y	N	N	Y	Y	N
Securities Broking	N	Y	N	N	N	N	N	N	N	L
Issuance of Insurance Policies	N	N	Y	Y	N	N	N	N	N	N
Mutual Funds	N	Y	Y	Y	Y	Y	Y	Y	Y	N
Real Estate Broking	N	N	N	N	Y	Y	Y	Y	Y	N
Travellers Cheques	Y	M	N	N	Y	N	N	Y	Y	Y
Financial Leasing	N	M	L	L	Y	Y	Y	Y	Y	Y
Computer Services	N	Y	Y	Y	L	L	L	L	Y	L
Credit Card Plans	Y	M	N	N	Y	N	N	Y	Y	Y
Portfolio Management	N	Y	Y	Y	Y	L	L	Y	Y	L
Investment Advice	N	Y	Y	Y	Y	Y	Y	Y	Y	N
Factoring	N	M	N	N	N	N	N	N	N	Y
Underwriting	N	Y	N	N	N	N	N	N	N	L
Registrar & Travel Agent	N	N	N	N	Y	N	N	Y	Y	M
Managing Sinking Funds & Acting as Corporate Trustee	N	Y N	N	N	Y	N	N	Y	Y	Y N
Investment Contracts	M	Y	N	N	N	N	N	N	N	M
Administrative Advisory & Management Services	M	Y	N	L	M	M	M	M	M	M
Indexed Security Investment Plan	Y	Y	Y	Y	Y	N	N	Y	Y	Y

Y - Yes N - No M - Maybe L - Limited

Source: Submission to the Ontario Securities Commission by the firm of Campbell, Godfrey and Lewtas, September, 1983.

Reproduced from Ontario Task Force on Financial Institutions(1984).

this offshore activity of banks is generating increasing concern about the adequacy of the domestic securities industry.

Fourth, and finally, Zysman's analysis also lends perspective to several of the major concerns currently in the policy limelight, particularly the new regulatory ground rules in Quebec and the holding-company proposals of the Green Paper. In terms of the former, Quebec has decided to move in the direction of 'financial integration,' i.e., an erosion of the four pillars or, more correctly, the three pillars, since the banking function is clearly outside provincial jurisdiction. Specifically, Quebec appears willing to allow its indigenous financial institutions (insurance companies and the caisses populaires) to broaden their range of operations even to the point of allowing them to enter underwriting and full-service brokerage. Not surprisingly, perhaps, other jurisdictions have become more than a bit concerned. And this is probably part of the reason why the federal government is taking a more serious interest in financial services.

However, what might seem an aberration in the Canadian context is not all that radical in the Zysman framework or, for that matter, in the American scene, where an insurance company can own a securities firm (Prudential-Bache Securities). One might even take this somewhat further. Combined with the aggressive and pro-Quebec investment policy of the Caisse de dépôts et placements, the province's move towards a single-pillar financial sector (excluding banking) might well be interpreted as a shift toward a state-led approach to economic adjustment, though a one-pillar system by itself need not imply state-led adjustment. One can rail, of course, against what Quebec appears to be doing, but it is important to note that while it may be offside with respect to the rest of the country, it is not offside with policies in some other parts of the industrialized world.

In terms of the proposals in the Green Paper, it is clear that the federal government is not contemplating a regulation-by-function approach to the financial sector, at least in the way that regulation by function is typically defined, i.e., one corporate entity being allowed to operate across the pillars. Phrased differently, the four pillars will be maintained. However, via the holding-company route, ownership integration will be in effect across the pillars, and, via networking, a common owner may be able to engage in cross-pillar activity. In this sense, the holding company can have the powers of the West German universal banks, even to the point of the intermingling of commercial

and financial interests (in terms of ownership of the holding company). A more detailed analysis of the Green Paper will follow later. For now it is sufficient to point out that this regulatory conception bears more-than-surface resemblance to models of the financial environment elsewhere in the world.

V THE CANADIAN FINANCIAL SECTOR

The Canadian approach, or perhaps more correctly, the Ontario approach, to the financial sector was summarized recently by the Ontario Securities Commission:

> Each of the major participants in Canada's financial system – the securities dealers, the banks, the trust companies and the insurance companies – has a core function. Public policy, as reflected in our laws, reserves to each group the performance of its core function. The Canadian financial system may therefore be described as a segregated system and the division of the system into four segments may metaphorically be referred to as the 'four pillar' concept. (1983, p. 11)

The 'core' functions for trust companies and insurance companies are rather obvious. For banking the core function has come to be defined as the ability to engage in commercial lending (at least in the view of W.A. Kennett, inspector general of banks (1982, p. 14). The OSC's decision on the T-D's Green-Line Investor Service (GLIS) effectively defined the core function of the securities industry as 'underwriting' or the new-issue process. In other words, the OSC allowed the T-D Bank to engage in discount brokerage because discount brokerage is not the securities core. In this way the OSC could and did argue that allowing the T-D Bank to introduce GLIS was consistent with the maintenance of the four-pillar policy.

While the market may be segregated conceptually into these four pillars, the jurisdictional overlay is not so neatly segregated. Section 91 of the Constitution Act, 1867 placed banking under federal legislation by virtue of one or all of currency and coinage [s.91(14)]; banking, incorporation of banks, and the issue of paper money [s.91(15)]; and savings banks [s.91(16)]. Trust companies are, for certain of their activities, regulated by the provinces[3] but can be incorporated under either federal or provincial charter. Insurance

companies generally come under both federal and provincial jurisdiction, while the securities industry is regulated provincially.

Thus, one of the issues that will be central in the remainder of this paper is precisely this jurisdictional and/or constitutional overlap. For example, which level of government should regulate the various segments of the industry? Constitutionally, which level of government can regulate the various sectors? This latter question becomes increasingly important as provincially chartered institutions (e.g., trust companies) become subject, for example, to federal monitoring under deposit insurance.

There is also a set of policy issues that, while closely related to the jurisdictional overlay, is conceptually separate. For example, even if all financial regulation fell to the federal government, there would still exist policy questions such as: should the four pillars be maintained, or should the system be allowed to integrate? Finally, a series of sector-specific issues looms large. Ontario's proposals for trust company regulation in the light of the Seaway-Crown-Greymac debacle is a good example.

Although the jurisdictional and policy issues are probably best dealt with in an analysis of the entire financial sector, for expositional reasons I shall deal with them by focusing in turn on financial intermediaries (Part VI) and market intermediaries (Part VII). In both sections, attention will be directed first to the existing lines of regulatory authority and potential changes in jurisdictional control. This will be followed by a focus on key policy issues and their interaction with the existing regulatory process. For example, should all deposit-taking institutions hold reserves with the Bank of Canada for monetary control purposes? Should regulation by institution give way to regulation by function? Should Canada adopt some version of the US Securities and Exchange Commission? To that degree should Canada ease up on the current ownership restrictions in the securities industry?

Prior to embarking on this analysis, however, it is important to recognize the degree to which the overall system does appear to be integrating. Canadians have read with considerable interest the apparent rapid integration of the US financial sector, and in particular how the Cash Management Account of Merrill Lynch has enabled this brokerage firm to lay claim to being, effectively, the first American nation-wide bank, a position not attainable by any commercial bank

by virtue of the 1927 McFadden Act, which limits the ability of banks to branch interstate. Moreover, Sears Roebuck, with its thrift, securities, insurance, and real estate activities, has become a 'one-stop financial supermarket' and indeed a one-stop 'everything' if one throws in its traditional line of products.

Some of the financial integration occurring in the United States is illegal in Canada. For example, American Express's acquisition of Shearson Loeb Rhodes or Sears Roebuck's purchase of Dean Witter could not occur in Ontario. Nonetheless, there has been considerable integration in Canada. Trilon Financial, an arm of Brascan, has London Life, Royal Trust, and Fireman's Fund Canadian under its wing. Power Financial Corporation has the Investor's Group, which controls Great West Life Assurance Company and Montreal Trustco. Midland Doherty has included chequing privileges with its free credit balances. And now Merrill Lynch Canada offers a Canadian version of the Cash Management Account, which, through networking, combines the investment services of Merrill Lynch with the banking services of the Royal Bank of Canada. Finally, the Laurentian Group is about to open Canada's first one-stop financial supermarket in Montreal. An overview of this tendency for financial integration is presented in Table 3, reproduced from the Ontario Task Force on Financial Institutions (1984).

I turn now to a more detailed analysis of the jurisdictional and policy issues at stake in the financial sector, dealing first with deposit-taking institutions.

VI DEPOSIT-TAKING INSTITUTIONS

Table 4 outlines the federal-provincial regulatory overlay relating to the principal deposit institutions – banks, trust and mortgage loan companies, credit unions, and caisses populaires. Were one to update this table, the principal new entry would be the Canadian Payments Association (CPA) – i.e., the nation-wide clearing system. This is a federally constituted agency to which all deposit-taking institutions in Table 4 have the right to belong, although some of the individual credit unions have gained access through their credit-union centrals. Previously, the chartered banks controlled the clearing system, and other financial institutions were required to clear through one or another of the banks. (I recall attending in the mid-1970s the provincial convention of the Saskatchewan credit unions, where one of

TABLE 4
Functions and responsibilities of the regulators of deposit institutions, 1975

	Federally incorporated		Provincially incorporated		
	Chartered banks	Trust and mortgage loan companies	Trust and mortgage loan companies	Credit unions	Caisses populaires
Federal					
Bank of Canada	Lender of last resort: regulator of liquidity				
Inspector General of Banks	Inspector: administrator of Bank Act				
Canada Deposit Insurance Corp. (CDIC)	Insurer of deposits: tender of last resort	Insurer of deposits: lender of last resort	Insurer of deposits (outside Quebec): lender of last resort	Lender of last resort	
Superintendent of of Insurance		Inspector: administrator of Trust and Loan Act, administrator of Small Loans Act	Administrator of Small Loans Act	Administrator of Small Loans Act	Administrator of Small Loans Act

	Federally incorporated		Provincially incorporated		
	Chartered banks	Trust and mortgage loan companies	Trust and mortgage loan companies	Credit unions	Caisses populaires
Minister of Consumer and Corporate Affairs	Administrator of Interest Act	Administrator of Interest Act	Administrator of Interest Act	Administrator of Interest Act	Administrator of Interest Act
Provincial					
Quebec Deposit Insurance Board (QDIB)			Insurer of deposits (in Quebec); lender of last resort		Insurer of deposits: lender of last resort
Registrar of Trust and Loan Companies		Licenser of business in provinces	Inspector; administrator of Trust and Loan Act; licenser of business in province		
Ministry of Financial Institutions (Quebec)					Inspector (delegated) to centrals; administrator of Caisses Populaires Act

	Federally incorporated		Provincially incorporated		
	Chartered banks	Trust and mortgage loan companies	Trust and mortgage loan companies	Credit unions	Caisses populaires
Supervisor of Credit Unions				Inspector; administrator of Credit Union Act	
Credit Union Reserve Board (some provinces only)				Insurer of deposits; lender of last resort	

SOURCE: Economic Council of Canada (1976).

the concerns was that the credit unions, which accounted for nearly 50 per cent of the cheques cashed in the province, were required to clear through a chartered bank, in this case the Royal Bank, which accounted for roughly 15 per cent of cheques cashed.)

Another omission from Table 4 is securities firms, which are now actively taking and transferring deposits. This innovation has caused considerable concern, principally for the chartered banks, which have argued that these deposits can bear a higher interest yield partly because they are not insured – i.e., not covered under the provisions of the CDIC. Indeed, from the vantage point of the depositor, they probably have to bear a higher yield precisely because they are not insured.

Setting aside the role of securities firms in deposit taking (an issue dealt with later), deposit-taking institutions are becoming more and more indistinguishable (in terms of their liabilities at least). Indeed, with the inauguration of the CPA, the spread of deposit insurance, and the advent of automated tellers, the Canadian consumer in his deposit and chequing roles probably views these institutions as essentially perfect substitutes. In other words, the system is integrating toward two 'banking' systems – one essentially under provincial control, and one under federal control.

Jurisdictional and policy concerns

The regulatory environment

Section 92 of the Constitution Act, 1867 placed trust companies (and presumably credit unions as well)[4] under provincial regulation by virtue of Property and Civil Rights [s.92(13)] and the Incorporation of Companies with Provincial Objects [s.92(11)] for regulation and for chartering respectively. However, as the near-banks move into new areas and as they establish contact with federal agencies or functions (such as deposit insurance), the degree to which they fall under provincial jurisdiction becomes increasingly questionable. For example, were the courts to define banking as the ability to accept deposits transferable by order, then all deposit institutions, even securities firms, would be subject to federal regulation. Even under the more likely scenario, where the courts, if asked, will define banking as the ability to engage in commercial lending, the boundaries are becoming progressively more blurred as both trust companies and credit unions are moving in this direction. The banking sector is crying foul, basing

its argument in large measure on the conflicts of interest that will arise for institutions engaged in both trustee relationships and commercial lending. Part of this concern probably reflects the fact that it is highly unlikely that the federal banking regulators will ever allow the banks to engage directly in ETA (estates, trust, and agency) activities. For their part, the near-banks can respond by noting that this encroachment really began when the banks were freed from their original prohibition against mortgage lending.

Regulation by function

In response to this jurisdictional and functional separation, the Economic Council of Canada in its 1976 study, *Efficiency and Regulation*, recommended a functional approach to regulation:

> Our overall concern about efficiency has led us to favour a functional approach to the regulation of deposit institutions. The functional approach involves the regulation of activities of deposit institutions on a function-by-function basis. Instead of restricting particular institutions to particular functions, all deposit institutions would be allowed to undertake similar functions, provided they met the regulatory requirements established for each function. New institutions would be able to choose the combination of functions that they could perform most efficiently and competitively within a functional regulatory environment. (p. 60)

In recommending regulation by function, the Council recognized that this would, on the regulatory front, probably involve a choice between dominance by the federal government or a high degree of co-operation and co-ordination between the provincial and federal regulatory authorities. The Council opted for the latter, largely on grounds of pragmatism rather than principle.

More recently, William Dimma (1984), chairman of the federal blue-ribbon Advisory Committee on Financial Institutions, also lent support to regulation by function:

> We favour conceptually a movement to regulation by function, while recognizing that there are many practical difficulties and while realizing that some regulatory concerns, like solvency, will continue to be dealt with on an institutional basis.

> The concept of a level playing field means greater fairness and this requires regulation by function. (p. 19)

Economists, as distinct from practitioners, would probably come down on the side of regulation by function and would probably go as far as throwing in insurance companies and the securities industry. To be sure, conflicts of interest would exist, but these have been handled in other jurisdictions (e.g., the American practice of Chinese walls in separating banking and trustee activities). However, there are some drawbacks to functional regulation. Principal among them is the solvency concern. From an efficiency standpoint, institutional diversification or regulation by function may be desirable. But solvency at base is an institutional, not a functional, issue. In effect, this is the concern about financial deregulation (or regulation by function) raised recently by Pierre Lortie (1984):

> Those of us who have been called upon to attempt to avoid or clean up the mess resulting from the demise of a financial organization know full well that the concept of functional regulation is not adequate in such circumstances. To correct or prevent problems which can have a dramatic impact on the trust Canadian financial institutions enjoy, a regulator must be in a position to take control of the total organization (assets and liabilities) not only of one arm or leg. (p. 12)

In Lortie's view, a move toward functional regulation will, in the final analysis, result in the establishment of a regulatory agency that will embrace all functions and that will be in a position both technically and from a power standpoint to control the total organization or financial holding conglomerate. In other words, under deregulation, 'a case will be made for the Canadian government to step in with a regulating framework governing the activities of all financial institutions' (p. 12). A corollary might be that if Quebec were to integrate the three pillars (excluding banking), it would probably have to put in place some overarching regulatory agency in order to limit the damage that would arise from an institution's problems in any one of the three pillars.

To some extent this integration is already occurring. The access of near-banks to both the CPA and to federal deposit insurance represents a step toward functional regulation. And in both cases, although more

so with deposit insurance, federal regulatory powers over provincially incorporated deposit institutions have increased.[5] I shall deal with each in turn.

Monetary control and the CPA

It has been argued in many quarters that for the Bank of Canada to exercise effective monetary control it is necessary that all institutions accepting deposits transferable by order be required to hold reserves with the Bank of Canada. The Economic Council of Canada's (1976) recommendations are representative of this view:

> We recommend that cash reserve requirements be applied to all deposit institutions on an equal basis according to the nature of their liabilities. Reserve requirements should only be levied against demand deposits, notice deposits, and term deposits with an earliest maturity of less than 100 days and should be set at a level of no more than 4 per cent of the relevant deposit liabilities. The holding of such reserves should be made a condition for direct access to the clearing system and for coverage under deposit insurance. Depending on the institution, these reserves could be held at either the Bank of Canada or an approved depository. (p. 69)

Prior to 1980 and the establishment of the Canadian Payments Association (CPA), the near-banks could take the view that since they were denied direct access to the clearing system it was inappropriate (and unfair) for them to be required to hold reserves with the Bank of Canada. The federal White Paper on banking legislation, tabled in 1976, which contained the proposal for establishing the CPA, recommended that *all* institutions accepting deposits transferable by order be required to join the CPA and to maintain minimum cash-reserve deposits with the Bank of Canada.

Not surprisingly, the near-banks objected to this proposal, and the provinces, led by Quebec, argued that it was unconstitutional, since the CPA was in effect making provincially regulated institutions subject to federal legislation. In my view the proposal would not have been unconstitutional, since the White Paper's proposals related to the near-banks in respect of their payment activities, an area of federal jurisdiction, not in terms of any regulations relating to the chartering of these institutions. In any event, the issue did not come

to a head because the federal government backed down from its original proposal in order to qualify for access to the CPA. The rationale for doing so was pragmatic, probably influenced substantially by the governor of the Bank of Canada, Gerald Bouey (1974), who argued that reserve requirements on near-banks were not essential for the Bank of Canada to exercise effective monetary control:

> Up to the present, I cannot blame any shortcomings in monetary policy on the technical arrangements that link the Bank of Canada to the rest of the financial system. The absence of cash reserve requirements applicable to depository institutions other than chartered banks has never, to my knowledge, frustrated the efforts of the Bank of Canada to bring about as sharp a curtailment of the pace of monetary expansion and as large an associated rise in short-term interest rates as we were prepared to contemplate in the circumstances of the time.
>
> Whether this would continue to be the case in future years if a growing proportion of the country's banking business were taken on by institutions other than the chartered banks is another question. In thinking about the adequacy of our present cash reserve arrangements for purposes of monetary control, one does have to consider the implications of a further possible decline in the chartered bank's share of chequable deposit business. A progressive loosening of the relationship between the amount of cash reserves supplied by the central bank and the probable responses of the institutions which provide the public with most of the money it uses for transactions purposes would undoubtedly make the effects of central bank operations less predictable. (pp. 22-3)

This 'progressive loosening' may now be more a factor, particularly in light of the later discussion of the Green Paper proposals.

The Canadian Deposit Insurance Corporation (CDIC)

Without question, the single most controversial issue pertaining to deposit-taking institutions relates to deposit insurance. Under the provisions of the CDIC, each eligible institution (including provincially chartered trust companies) has its deposits guaranteed up to a maximum of $60,000 per depositor. Provided these institutions meet the CDIC requirements, this protection is available at a uniform fee

(one-third of 1 per cent of insured deposits) regardless of the characteristics of the institution. Deposit insurance generates two sorts of incentives: first, it reduces the incentive for depositors to assess the risks of different financial institutions, and second, it increases the incentives for the management of financial institutions to take risks. Neither of these implications is desirable, but each is the result of our present system of deposit insurance. In effect, the system is guaranteeing depositor protection at the expense of some increased probability of insolvency.

An example may be instructive. The combination of the allowance of dominant shareholders for trust companies, the existence of single-premium deposit insurance, and the provision for the allocation of a portion of trust company assets into real estate can provide an open invitation for abusing the system. If the investment falls through, the depositors are protected. If it succeeds, the windfall accrues in large measure to the principal shareholder. This is not to say that the trust companies are managed by a group of persons likely to engage in this sort of activity. The opposite is almost assuredly the case. However, the incentives in the system are such that, if an owner is so inclined, the way is open for this type of action. Thus the issue becomes one of ascertaining how far the system should go in producing inappropriate incentives, since 'no-loss' arrangements are in obvious conflict with the precepts of an efficient financial system.

The deposit-insurance controversy has tended to become a federal-provincial debate largely because until recently the institutions that have had to appeal to the CDIC have been provincially regulated even if some have not been provincially chartered. In turn, this situation has led the chartered banks to argue that they are in effect subsidizing, via the CDIC, some of these more risky institutions. The recent bailout of the Canadian Commercial Bank will no doubt serve to muffle somewhat the chartered banks' voice in this regard, but the issue nonetheless merits attention – unconditional single-premium deposit insurance is inappropriate. There are many potential solutions to the problem. At one extreme, the system could move toward co-insurance. Under such an arrangement, some initial level of deposits might be fully insured, with decreasing insurance for deposits above this level. At the other, deposits would be insured but the premiums would be variable. The Economic Council of Canada (1976) recommended this latter approach:

> We recommend that the Supervisor of Deposit Insurance implement a system of variable premium rates for deposit insurance, according to established criteria reflecting the differences among institutions with regard to potential claims on the insurer. (p. 66)

The Council points out that while this approach will involve some judgement calls, similar problems have been overcome by bond-rating agencies and by bank regulators in other countries. Among the criteria for assessing the variable rate premiums, the Council suggests the 'volume of uninsured liabilities and their maturity relative to insured liabilities, the maturity structure of assets relative to liabilities, past loss experiences, and the size and diversification of the institution' (p.66). I would suggest that some consideration be given to exacting a higher premium for closely held institutions.

In any event, the status quo is untenable. Either the system moves to an insurance basis or the institutions ought to be subject to the full supervision and regulations of the CDIC. Federal bailouts to cover for inadequate provincial regulation or supervision are unacceptable.

Part VI to this point has been a very selective review of several policy issues affecting the deposit-taking institutions and, more generally, financial intermediaries. Rather exhaustive overviews of the issues appear elsewhere (e.g., Ontario Task Force on Financial Institutions, 1984). Moreover, some of the issues that also affect financial intermediaries are dealt with in Part VII, on market intermediaries. Nonetheless, the brief review highlighted the fact that, in their deposit-taking function, the various institutions are becoming increasingly similar, so much so that one can probably now view the system as comprising two banking systems, one federally and one provincially controlled. But this process of financial intergration has led to an even greater jursidictional regulatory overlay. In particular, the provincially chartered institutions are increasingly becoming involved with federal agencies such as the CDIC and the clearing system (although in principle there is no reason why these agencies could not be 'national' rather than federal). We are thus seeing, in effect, a move toward regulation by function. The intriguing question is whether this will inevitably lead to a greater federal regulatory presence.

To a large degree these musings have been superseded now that some of the task forces on financial regulation have issued position papers. As a conclusion to this section on deposit-taking institutions, I shall focus on these reports and, in particular, on the federal Green Paper.

The federal Green Paper

Underlying the analysis in the federal Green Paper (Government of Canada, 1985) are several principles with which I am in full agreement. For instance, 'in a fast-changing financial world, regulatory policy should avoid as much as possible the imposition of a preconceived structure on the financial system,' and there ought to be a 'greater degree of flexibility in institutional arrangements.' In effect, the stated underlying goal is to promote competition, innovation, and efficiency.

How one attempts to convert principles into practice is quite another matter. In terms of introducing greater competition into the area of commercial lending, the Green Paper focuses on two broad alternatives (p. 3): widening the commercial lending powers of trust companies and other non-bank institutions, or allowing financial holding companies to own a bank (to be known as a Schedule C bank). The Green Paper opts for the second alternative. In effect, this amounts to a reassertion of the prevailing institutional four-pillar separation, but it allows the pillars to crumble via common ownership through a holding company. Hence, trust companies will not be able to extend their commercial lending activities, but the owners of a trust company can get into commercial lending if, through a financial holding company, they acquire a Schedule C bank. And subject to provincial regulations, the federal proposal would allow financial holding companies to own market intermediaries.

As an aside, I must admit that I was a bit surprised to find that the driving force behind the Green Paper was the lack of competition in the commercial lending area. To my knowledge, the Schedule B banks are not making excess profits. Quite the contrary. The Green Paper does not provide much if anything in the way of evidence for its position. I presume that the issue arises because the trust companies are running into rough sailing. Their mortgage markets have not been expanding much, thanks to the chartered banks and demographic trends, and so they are looking for greater room to manoeuvre

in the area of commercial lending. Unfortunately, the Green Paper does not address the pros and cons of the most obvious alternative – to allow the trust companies more access to commercial lending – although it does provide some hints, as we shall see later, as to why it might have ruled out this option.

In effect, then, if one focuses on the relation between financial and market intermediaries, there are now three competing approaches to this general area. The first is the existing 'Ontario approach', which argues for both functional separation and ownership separation. Quebec has opted for functional integration or regulation by function, whereby market intermediaries such as insurance companies can enter brokerage and underwriting if in performing these functions they abide by the regulations applicable to market intermediaries. Finally, the federal Green Paper has come down in favour of functional or institutional separation but has opted for ownership integration.

Two underlying rationales

No doubt there are many reasons why Ottawa is pursuing this approach. Let me dwell on just two possibilities. The first relates to solvency concerns. On the one hand, the financial intermediaries have been plagued recently with a number of costly failures. On the other hand, there is an ongoing movement toward financial integration, driven by technology and developments south of the border. As noted earlier, one potential problem with regulation by function is that solvency is, at base, an institutional problem, not a functional problem. Hence, the financial holding company route can seemingly accommodate both of these concerns. Financial integration comes about via separate institutional or corporate entities, and if something goes awry with one of the holding company subsidiaries the relevant regulator can zero in on the institution in question and limit the damage, so to speak. But, in order to control the conflicts of interest that could arise in such a multi-function holding company, the federal government is in effect imposing an outright ban on self-dealing of all sorts. Several issues arise in this context.

First, will potential gains or synergy from financial integration through a holding company be dissipated via the stringent requirements on self-dealing and concern over the abuses of conflicts of interest? An economist's answer might be to let the market decide – if

agents opt for the holding company route then this is prima facie evidence that there are gains to be had from the new structure. Thus far, the chartered banks' response to all this would appear to be to question this line of argument: in effect they appear to be arguing that the holding company route might clearly be deemed desirable by agents precisely because it will be effectively impossible to regulate against self-dealing. This is one area where one probably has to await the forthcoming technical paper associated with the Green Paper in order to assess whether or not the self-dealing provisions are likely to be enforceable and, if so, whether they will serve to undermine the synergy gains.

Conflicts of interest are quite a different matter. The very nature of financial intermediation involves such conflicts. Hence, what one wants to control is abuses of conflict of interest. In my view the discussion to date tends to focus too exclusively on the potential conflict abuses between the pillars, when in fact the conflicts within each pillar can be every bit as problematic. But we have managed, via regulation, to live with the latter. It is possible that we are overestimating the magnitude of the former or at least underestimating our ability to deal with them in ways that will not offset the efficiency and innovation gains arising from the holding company approach.

A second issue relates to the solvency issue. The experience of the Continental Illinois in the United States suggests that the bailout of Continental eventually had to be extended to the financial holding company as well. Thus, the holding company route might not be as effective a device for monitoring and limiting financial disasters as might at first appear. In any event, it is my view that the notion that solvency is an institutional and not a functional concern played a role in the design of the Green Paper proposals. Those wishing to challenge the Green Paper must come to grips with this concern.

However, there is a second, and far more controversial, interpretation of the design of the Green Paper. This is that it represents a concerted attempt on the part of Ottawa to undermine provincial jurisdiction in the financial arena and to centralize regulation of the Canadian financial sector. Indeed, in this sense it is more in tune with policies of the previous federal government such as the National Energy Program than it is with the spirit of federal-provincial accommodation that is generally assumed to be the prevailing approach of the Mulroney government. Party politics aside, there can

be no doubt about the centralizing nature of the Green Paper proposals. The financial holding company would have to be federally incorporated if a federally regulated financial institution were among the subsidiaries of the holding company. And, as one might expect, if the holding company opted for a Schedule C bank, the holding company would have to be federally incorporated (as, of course, would the bank). Thus, to the extent that there is a desire among provincially incorporated and regulated financial institutions to move into the area of extending commercial credit, the holding companies would have to be federally incorporated and regulated.

The encroachment on provincial jurisdiction does not stop here. The real jurisdictional sleeper in the Green Paper is the provision for holding companies to acquire, subject to provincial approval, securities firms. Consider the following scenario. A federally incorporated holding company acquires a British Columbia securities firm, with the province's approval. The securities firm then attempts to trade and/or operate in Ontario, and the Ontario regulatory authorities prevent it from so doing because this would run counter to Ontario Securities Commission (OSC) and Toronto Stock Exchange (TSE) requirements. The stage is then set for a constitutional challenge on the issue of whether a provincial regulatory agency can prohibit a 'federally chartered' securities firm from trading on the TSE. As I will argue in the next section, the courts have several federal heads of power on which to overturn the long-standing provincial jurisdiction over the securities industry. My hunch is that the federal government would eventually win such cases. This would then open the door not only to federally regulated securities firms but also to a Canadian Securities and Exchange Commission at the federal level to oversee the workings of the entire market intermediary sector. No doubt such a model would appeal to many Canadians. Indeed, it may have appeal to some of the provinces as well. And it clearly is a viable alternative, since it would be the prevailing prototype in most federal nations. But as the next section will argue, the provinces have done, and are continuing to do, an admirable job of regulating market intermediaries, so that such a substantial jurisdictional grab is questionable on efficiency grounds and any transitional period is bound to be fraught with both confusion and confrontation. Moreover, the argument that competition is healthy applies, in my view, to competition among regulatory jurisdictions. Nevertheless, embedded in the

Green Paper are these seeds of federal ascendancy across the four pillars.

This framework (i.e., federal ascendancy) also allows one to rationalize one other feature of the Green Paper proposals. While the provincially regulated financial institutions can access the holding company route in order to engage in cross-pillar activities, this avenue is blocked for the chartered banks, although discussions for the next round of Bank Act revisions are set to begin immediately. This reining-in of the banks is obviously appealing to the non-bank financial intermediaries and will no doubt lead them to pressure their respective provincial regulatory authorities to go along with Ottawa's proposals.

Thus, from this vantage point, the federal government is using its authority over banking (commercial lending) as a stepping-stone to widen dramatically its control over the entire Canadian financial sector. The last time that Ottawa played this card was in connection with the proposed Canadian Payments Association, where, in return for direct access to the clearing system, all near-banks would be required to hold reserves with the Bank of Canada. As noted earlier, the provinces, led by Quebec, successfully overturned this attempt by Ottawa to increase its regulatory orbit. This time around Quebec has thus far been remarkably silent. Perhaps it is because there appear to be 'grandfathering' provisions in the federal proposals to the effect that if existing provincial legislation allows one type of financial institution to hold another type of financial institution incorporated as a subsidiary, then the federal holding-company requirement would be set aside. For its part, Ontario is hardly in a position to mount much of an attack, since it has been quite unable to get its own act together in the wake of the Seaway-Crown-Greymac debacle, although the interim report of the Ontario Task Force on Financial Institutions (1984) has recommended prohibitions against self-dealing in the trust company area. Finally, as noted above, it may well be that some of the provinces would welcome an enhanced federal role.

Altering the banking environment

The federal proposals also alter rather dramatically the historical and analytical approach to banking in this country. Traditionally, banking or commercial lending (at least for Schedule As) has come to be limited to federally chartered institutions that were widely held.

The formal requirement to be widely held dates only from 1967, however. But under the Green Paper proposals, federally chartered holding companies, which need not be widely held, can incorporate Schedule C banks. Schedule B banks can under some circumstances become Schedule Cs. And there is even a hint that some Schedule A banks may be brought under the umbrella of a federal holding company.

It is surely only a matter of time before Power Financial and Trilon, via federal holding companies, acquire Schedule C banks and put together closely held financial empires that rival the 'big five'. (A recent Canadian Bankers' Association position paper (1985) argues that in terms of size of domestic assets we are not far from this situation now.) When this occurs, the Canadian notion of fair play will surely argue for 'levelling the playing field' and allowing the Schedule A banks more flexibility, including, I suspect, the possibility that they too could come under the control of a narrowly held holding company.

There is a related concern. Federally incorporated holding companies will be allowed to own both Schedule C banks and, the provinces willing, securities firms. Once again the level-playing-field will argue that eventually the Orions and CIBCs (London) of this world be allowed to operate within Canada. This may well be an appropriate step, particularly in light of the argument in the next section to the effect that there is a pressing need to open the securities industry to more competition. But for present purposes the point at issue is that this also represents a break with the tradition of keeping banking and underwriting separate. While these last two points suggest that, over time, the notion of the level playing field will eventually lead to enhanced powers for the banks as well, the immediate thrust of the Green Paper proposals is to keep the banks on hold. Temporarily at least, rather than levelling the playing field, Ottawa has levelled one of the players. As Grant Reuber has pointed out (1985) this is likely to result in two wrenching adjustment periods – the initial one, characterized by a protected environment where the banks are kept on hold, and the second one when the reins are taken off the banking sector.

I recognize that it may be the 'in' thing these days to rail against the powers of the chartered banks. I also recognize that there are also long-standing regional grievances that feed this feeling. But we should not overlook the fact that the banks are widely held (in terms

of ownership) and that the last chartered bank failure occurred in the early 1920s (abstracting from mergers and, of course, the delicate position of the CCB). One can, of course, mount an infant-industry-type argument that in opening up the system it is appropriate to allow the smaller group a reasonable head start. I suspect that even the banks would go along with this. But the notion that Trilon or Power Financial is a 'small guy' or an infant does stretch to the extreme this notion of levelling the players. There is also a larger issue at stake here. In my view the overall goal of financial reform has to be two-fold. First, we have to devise a financial structure that best suits Canada's needs in the 1980s and 1990s. Second, we ought to aspire to ensure that our financial institutions are world-class, both because we should settle for nothing less and because there exist avenues for exporting our expertise that should not be ignored. As a nation we cannot afford 'internal equality' if the end result is that we have second-class institutions in the international pecking order. For too long now this looking inward has been an expensive obsession.

This comment aside, the longer-term implications of the Green Paper suggest that the traditional banking environment will be transformed in at least three ways: banks will no longer be required to be widely held; the separation of commercial and banking functions will disappear, since commercial enterprises will be able to hold banks through holding companies; and the separation between banking and underwriting will disappear, at least at the ownership level. As noted earlier, these implications effectively amount to converting the Canadian financial sector, via the holding company route, into a facsimile of the West German universal bank approach.

Evaluation

To this point the description-cum-analysis of the Green Paper proposals has been quite negative or at least directed toward airing the range of concerns that are likely to be associated with its implementation. This has been by design since the proposals involve sweeping changes to the regulatory status quo and it is critical that the implications of some of these changes be spelled out. It was also motivated by the rigid stance that Ottawa appears to be taking toward the Green Paper – there is room for tinkering at the edges, but the core of the reform is part of the 'sacred trust' that has recently gained favour in the corridors of power.

However, with this elaboration of implications as backdrop, one can now move to the next step and attempt to evaluate the proposals, particularly in terms of what they are likely to imply about efficiency and innovation. To do this requires answers to a series of questions. The first of these is whether or not commercial lending is the priority area for enhancing competition in the financial sector. As I shall argue later, I do not think it is. The area where enhanced competition and innovation is needed most in order to facilitate Canadian economic adjustment is in the securities industry or more generally in the area of access to equity capital. To be sure, the Green Paper proposals will be of value in this respect if they provide a catalyst for the provinces to open up the market intermediaries to greater competition. My fear, however, is that they will serve only to delay provincial action, since it will be extremely difficult to legislate new securities provisions within an overall financial sector that is undergoing rapid and uncertain change. However, one does have to admit that the willingness of the federal government to allow holding companies to acquire securities firms may be precisely what is needed to move the securities industry away from its present protectionist mould. These issues will be dealt with later.

The obvious next question is why Ottawa opted for this particular route. Apart from the solvency and federal ascendancy rationales aired earlier, one answer has to be to increase competition. To the extent that the proposals really succeed in this goal, then one's criticisms have to be muted substantially, if not converted into support for the proposals, because the essential role of the financial sector is to transfer savings efficiently from lender to borrower. I have no doubt that on balance competition, at least initially, will be increased. But it will also come at a cost. One cost is the regulatory network that will have to be put in place to monitor the potential for self-dealing. Another cost, much harder to monitor, might occur if a competitor of one of the entities is denied access to the resources of the entire set of institutions under the holding company. This latter concern has to do with the potential for increased concentration that could follow in the wake of implementation of the Green Paper proposals. It is not difficult to foresee financial holding companies acquiring large financial institutions in each of the pillars so that the net result may be that a very substantial portion of Canadian savings will flow through a limited number of holding companies. If and when

the Schedule A banks become part of the process, this concentration will be aggravated.

Perhaps the most favourable view one can take is that the stage will be set for companies to more easily find one-stop shopping when it comes to putting together an overall financing package (e.g., equity, loans, and debentures) – a composite financial 'bought deal', as it were. (In this context, the Green Paper's prohibition against 'tied sales' will also be difficult to monitor.) To the extent that this is the overall result of the proposals, it clearly allays somewhat my earlier point that an insurgence of competition in the securities area is of more importance to the economy than increased competition in commercial lending.

Implicit in the reason why the Green Paper went this particular route must have been a recognition on the part of Ottawa that the alternatives were less appealing. Allow me to spell out one of these alternatives. Since banking falls under Ottawa's constitutional authority, the first step would be to define banking as engaging in commercial lending. Next, any institution that engages in commercial lending must be subject to the same sorts of regulations as are the banks. This would include holding reserve requirements with the Bank of Canada and being subject to the appropriate regulations. Included also might be thresholds for commercial lending depending upon such factors as how widely held the institutions are. The control over abuses of conflict of interest would take the form of Chinese walls which, perhaps surprisingly, appear to have worked rather well in other jurisdictions. Such an approach would of course fall more into the regulation-by-function model. In addition to being concerned about regulation-by-function, the federal government may have vetoed this alternative because the near-banks were already narrowly held and financial holding companies already exist. In this sense, one can view the Green Paper proposals as an attempt to lend some federal control and direction to the types of ownership and institutional developments that already exist – a 'leaning-with-the-wind' approach, as it were – while at the same time implementing generalized self-dealing prohibitions to stave off the sorts of financial disasters that also have proved to exist already in this new environment. However, this approach may not be able to prevent the ongoing integration occurring within each of the pillars. Hence, the net result under the Green Paper proposals will likely be some further cross-pillar activity

by existing institutions as well as the ownership integration and functional separation deriving from the holding company approach.

In general, the issue boils down to focusing on alternative general approaches in terms of comparing the efficiency and competition gains on the one hand and the downside problems associated with conflict of interest and self-dealing on the other hand. On this trade-off, I side with Bill Dimma (1984), when he notes that 'on the issue of conflict of interest the Committee leans toward a permissive approach to combinations while maintaining a tough approach to abuses' (p. 9). One can interpret the Green Paper proposals as falling within this general framework, but so does a regulation-by-function approach (indeed, as noted above, the Dimma Committee did appear to lean toward the latter).

In summary, if the Green Paper were to be viewed as a true discussion paper, then one would have to greet it with considerable excitement because it does introduce a new approach to the entire financial sector. Moreover, it provides a backdrop against which alternative approaches can be compared and contrasted. The concern about the Green Paper mounts if, as Ottawa has suggested, the approach is effectively cast in stone and the ongoing discussion and debate are simply to add or subtract a few bells and whistles. This is not to suggest that it may not contain within it the seeds of a substantial increase in competition and efficiency. Rather, it is a comment on the fact that, for commercial banking at least, it marks a sharp break with our traditions. In a rapidly changing world financial environment there is clearly a danger in sticking to tradition in the face of competitive pressures pointing in the opposite direction. But there is also a danger in not searching out alternative ways of accommodating any such competitive pressures, since one must assign some economic value to the social capital bound up in our time-tested approach to such areas as banking.

Perhaps the most immediate implication of the Green Paper for Ontario is that it lends a sense of urgency and focus to the ongoing deliberations of the Ontario Task Force on Financial Institutions. Given that Ottawa felt free to wade deeply into provincial territory, the Ontario Task Force will probably also feel free to devise models of the financial sector that include the activities of chartered banks. At least, one would hope that it would.

In addressing the range of issues relating to the securities industries, I shall follow roughly the same format as in Part VI for deposit-taking institutions, dealing in turn with the current structure of the industry, the jurisdictional overlap and the case for greater federal control, policy concerns currently at centre-stage, and the recent regulatory reports.

Recognizing that most readers are already familiar with the basics of the industry structure, the brief details pertaining to regulations, ownership, exempt markets, and the like are relegated to an appendix to this paper.

The regulatory environment

Provincial dominance

The securities industry in Canada is under provincial control.[6] Professors Philip Anisman and Peter Hogg (1979) comment as follows on the dominance of the provinces in securities legislation:

> The provinces have enacted securities legislation under their authority to legislate in relation to 'Property and Civil Rights in the Province' which has been interpreted to include contracts dealing with property and the regulation of businesses, trades and professions. Provincial power in relation to the securities market in particular has been generously interpreted by the courts. In 1932 the Privy Council upheld the Alberta Security Frauds Prevention Act, 1930, as a valid exercise of provincial jurisdiction intended to protect local investors from fraudulent practices and the case, now the leading decision in the field, has been broadly read so that in most instances in which a question concerning the validity of a securities act has arisen, the provincial legislation has been upheld. Judicial sympathy for provincial securities legislation is reflected even more dramatically in a number of decisions which held that no conflict exists between federal legislation and overlapping provisions in the securities acts. (p. 144)

The authors observe: 'The reluctance of the courts to strike down provincial securities legislation likely stems in part from the fact that there is *no federal securities law* so that a declaration of the invalidity

of a provincial act or any of its provisions would create a potential gap in the existing regulatory scheme that might be exploited by the unscrupulous' (p. 145, emphasis added).

As part of the provincial regulatory influence over the securities area, each province has some version of a securities act with a corresponding securities commission to administer the act. For example, in the province of Ontario the Ontario Securities Commission (OSC) administers the Ontario Securities Act. Moreover, much of the regulation in the securities area is in the nature of self-regulation. Among the self-regulated organizations (SROs) that fall under the umbrella of the OSC are the Toronto Stock Exchange (TSE), the Broker-Dealers Association of Ontario, and the Ontario operations of the Investment Dealers Association of Canada (IDA). Each of these associations is vested with (self-)regulatory powers. The five stock exchanges in Canada (Toronto, Montreal, Winnipeg, Alberta, and Vancouver) are governed by their respective provincial securities commissions.

The situation is very different in the United States. Partly in recognition of the fact that the various stock exchanges were an integral part of national economic life, Congress enacted the Securities Exchange Act of 1934 which created the federal Securities and Exchange Commission (SEC) to oversee the securities industry. However, it was not until the Securities Reform Act of 1975 that the SEC was put on notice to direct and supervise the development of a national market system for securities. It is this development, among others, that has motivated some analysts to recommend in Canada greater federal involvement in the securities industry, an issue I shall turn to shortly.

The nature of securities regulation

As the Royal Commission on Banking and Finance (1964) noted two decades ago:

> The philosophy of securities regulation in Canada is based on two principles, full disclosure and the prevention of fraud. The first is supported by securities and company legislation and the regulation of stock exchanges, while the second rests on the preventative and punitive powers of the securities laws and the federal Criminal Code as well as those of the by-laws and regulations of the self-regulating associations. (p. 345)

The manner in which these principles are implemented is outlined to some degree in the appendix. In addition to these two 'policing' functions of regulation (to fall back on the earlier terminology), there are several 'planning' functions, usually referred to as overriding public policy objectives. The recent OSC report (1985) on ownership lists two of these overriding goals – keeping the industry Canadian and preserving the four pillars.

Because of the dominance of the TSE and the OSC, securities regulation has tended to be more national in scope than one might expect from a decentralized regulatory process. With some important exceptions, Ontario has normally taken the lead in setting the regulatory pattern and the remaining provinces have tended to follow Ontario. Nonetheless, the existing network of regulation is not characterized by either complete uniformity or full harmonization. This has led many analysts to argue that there can be no true national securities market unless there is more federal involvement. Even the OSC (1967) put forward its CANSEC proposal ('The Case for a National Securities Commission') for a national presence in the regulation of the securities market. Commenting on this proposal, Howard (1979) makes the following observations:

> In its discussion paper on CANSEC the Ontario Securities Commission pointed out that with respect to securities market regulation in Canada the ideal system would embody uniform laws, uniform administration, a common data base and an expert staff to do policy analyses and research specific problems, to investigate problem cases and to administer the overall system. However, the discussion paper goes on to point out that the present Canadian system did not develop with ideal goals in mind but rather in response to different problems in different jurisdictions. Consequently the issue was characterized not as development of an altogether new system but coordination of existing systems to increase administrative efficiency and to develop a mechanism that will enable policy makers and administrators realistically to seek to achieve those ideal goals and so overcome the present dilemma of balkanized provincial regulation: on the one hand, only the larger provinces have the volume of securities business to justify both a sound act and the expenditure of substantial resources on effective administration. As a result the larger provinces – through sheer competence – necessarily

> attract the major business and thus tend to dominate the field. The major problem therefore in designing a Canada-wide securities regulation system is to reconcile centralized policy making with decentralized administration in a way that does not relegate any jurisdiction, federal or provincial, to an ineffective status. (p. 1690)

Arguments for a federal presence

The increasingly interprovincial and international nature of the securities business, the spread of computerization, which may eventually replace the trading floors of the stock exchanges with a Canada-wide automated trading system, and the inherent difficulty of applying provincial regulatory measures beyond provincial boundaries lead Anisman and Hogg (1979) to argue for an overarching federal role in the securities area. After citing numerous cases that have created problems for the provincial regulatory authorities, they conclude:

> It is clear, therefore, that the limitations on provincial jurisdiction not only cast doubt on the ability of the provincial commissions to enforce their own acts in connection with interprovincial and international transactions but also on the ability of the provinces, even acting cooperatively, to enact a scheme that will satisfactorily regulate the entire securities market. It goes without saying that similar restrictions do not apply to the federal government's ability to legislate; indeed, it is clear that Parliament may enact legislation with extraterritorial impact. In summary, it is fair to say that limitations on provincial legislative jurisdiction may create serious impediments to pervasive regulation of the Canadian securities market by the provinces. Despite their having filled an otherwise regulatory void, particularly by cooperative efforts which have been accelerated in recent years, it appears that some form of federal legislation to ensure a comprehensive scheme of securities regulation in Canada is warranted. (pp. 150, 153)

Anisman and Hogg suggest (1979, chapter 3) that the federal government might find constitutional support for entering the securities field under one or all of the trade and commerce power; section 92(10), the 'general advantage clause'; Peace Order and Good Government; or

the criminal law power. The Supreme Court's recent decision in *Multiple Access Ltd.* v. *McCutcheon* indicated that at least one justice is favourably inclined toward federal securities legislation of some sort. As I have hinted in the earlier discussion of the Green Paper proposals, my own view (albeit uninformed in these matters) is that the federal government would eventually succeed in moving into the securities regulation area.

Support for a federal presence came also from the Royal Commission on Banking and Finance (1964). Although it had some reservations about the operations of the SEC south of the border, and although it recognized that much has been accomplished in terms of provincial co-operation, the commission concluded that 'the job which remains to be done is likely to be accomplished most effectively if a federal agency takes the lead in setting high and uniform national standards' (p. 349).

Those in favour of a greater federal presence are not without some substantial evidence on their side. Again, from Anisman and Hogg (1979):

> On occasion parochial interests have even become dominant to the detriment of the efficient functioning of the market. The prime example is the implementation of a policy in 1969 by the Quebec Securities Commission requiring orders received in Quebec to be filled on the Montreal or Canadian stock exchanges; the application of the policy as a basis for disciplining a registrant for executing a Quebec order on the Toronto Stock Exchange resulted in a retaliatory amendment to the Toronto Stock Exchange's by-laws precluding arbitrage transactions by its members with the Quebec exchanges and thus served to some extent to balkanize the Canadian market. (p. 142)

This was indeed a retrograde step. It passed on to the investor the task of deciding which was the appropriate province in which to place a buy or sell an order. As of 1977, arbitrage between the exchanges was again permitted. There are no doubt many other instances when competition between the various stock exchanges and provincial securities commissions can be viewed in a negative light. But compared to what? The position I take on this issue is that the provincially regulated capital markets have served the country admirably. However, this does not mean that the status quo is satisfactory.

Indeed, I shall argue later that the dual pressures of technology and the increasing globalization of capital markets require a substantial rethinking of our securities legislation. But prior to addressing these issues, let us focus on alternative regulatory models.

Alternative regulatory frameworks

Table 5, adopted from a paper by John Howard (1979), presents fifteen alternative models for regulating the securities industry in a federal nation. Model 1 gives all powers to the federal level. Models 2 through 14 progressively decentralize regulatory authority, culminating with model 15 which assigns all authority to the provinces. Model 15 reflects the current Canadian regulatory environment. This is in sharp contrast to the US system, which is typified by model 3, where all secondary market regulation is federal and the individual states are restricted to variations in standards and in disclosure rules in the new issues markets. Moreover, as the table indicates, there was (in 1979, when the table was assembled) a move toward even greater centralization of authority in the United States (see model 2).

In discussing these alternatives, John Howard (1979) essentially dismisses the pure versions of the 'unitary systems' (i.e., federal dominance) as being unfeasible in Canada for both constitutional and historical reasons. For example, provinces would surely have the constitutional right to control intraprovincial issues. Howard settles on model 6 as the only unitary prototype that has any probability of adoption, and 'it is only unitary in the sense that all *administration* is vested in one level of government, that is, the provincial level' (p. 1704). On the pros and cons of this modified unitary approach, Howard notes:

> Model 6 has several distinct advantages: it gives the federal government considerable influence over Canada-wide securities market policies with a minimum of administrative overlap and, as a corollary, preserves much provincial autonomy; it obviates compliance with two levels of regulation; it makes maximum use of experienced personnel, and it is flexible in the sense that it enables decentralized decision making in a manner that is sensitive to local conditions. The signal disadvantages of such a system are that federal influence may prove to be rather tenuous, particularly where federal policy is

TABLE 5
Models of securities market regulatory systems

Model number	Federal law		Concurrent federal and provincial laws		Provincial law	
	Primary	Secondary	Primary	Secondary	Primary	Secondary
1	All except intraprovincial issues	All				
2	All except intraprovincial issues but subject to added provincial substantive standards (proposed US Federal Securities Code)	All				
3	All except intraprovincial issues but subject to added provincial substantive standards and disclosure rules (present US)	All				
4			Federal law – federal issuers – foreign issuers – interprovincial issues Provincial law – intraprovincial issues	Federal law – all (except intraprovincial trades not made through an interprovincial system)		

Model number	Federal law Primary	Secondary	Concurrent federal and provincial laws Primary	Secondary	Provincial law Primary	Secondary
5			Federal law – federal issuers – foreign issuers Provincial law – interprovincial issues – intraprovincial issues	Federal law – all (except as in 4)		
6			Same as 4 but federal law administered by provinces	Federal law – all (except as in 4)		
7			Same as 5 but federal law administered by provinces	Federal law (except as in 4)		
8			Either model 4,5,6, or 7	Provincial law – all		

Model number	Federal law Primary	Federal law Secondary	Concurrent federal and provincial laws Primary	Concurrent federal and provincial laws Secondary	Provincial law Primary	Provincial law Secondary
9			Federal law – federal issuers – foreign issuers Federal and provincial law (province of incorporation or head office) – interprovincial issues Provincial law – intraprovincial issues	Federal law – all (except as in 4)		
10			Federal law and provincial law (province of incorporation or head office) – federal issuers – foreign issuers – interprovincial issues Provincial law – intraprovincial issues (even of federal or foreign corporation)	Federal law – all (except as in 4)		

Model number	Federal law Primary	Secondary	Concurrent federal and provincial laws Primary	Secondary	Provincial law Primary	Secondary
11			Either model 9 or 10	Provincial law – all		
12		All			All	
13			Joint commission that acknowledges federal jurisdiction over inter-provincial trades			
14			Joint commission that does not so acknowledge (CANSEC)			
15					All (present Canada)	All (present Canada)

SOURCE: Howard (1979), Table 6.

> not congruent with provincial policy or administrative practice; that there is no strong incentive to develop uniform statutes and procedures, and that centralized information processing is improbable. Although a possible model, for these reasons it is unlikely to obtain much support. (p. 1704)

A second approach to regulation is a 'dual' system. Model 10 is Howard's choice of a workable version of such a system:

> Model 10 has the advantages that it preserves both provincial and federal autonomy within their respective jurisdictions, but because it requires a separate federal commission inherent in it are two clear disadvantages. First, it institutionalizes a dual system and therefore creates few if any incentives to achieve uniformity of policies and administration. Second, and even more important, assuming a decentralized federal commission administered through regional offices, it does not make the efficient use of experienced regulators. In effect, it would superimpose another level of regulation on the existing system, except to the extent that duplication of work could be avoided through the use of common disclosure standards and the use of techniques of notification and coordination to simplify the qualification of prospect uses. Judging from the almost unanimously hostile response to the partial two-level system proposed in part XV of the BUSINESS CORPORATION PROPOSALS, published by Consumer and Corporate Affairs Canada in 1971, model 10 is not likely to find favor with the federal government, any provincial government, the securities firms, or the professional advisers of those firms. (pp. 1704-5)

The third approach is an 'integrated' system. Howard focuses on model 13 as the prototype for this model of regulation:

> The third alternative is the integrated system referred to as model 13, which assumes broad, federal legislative power and delegation from the federal Parliament and the several provincial legislatures of comprehensive regulation-making (i.e., legislative), adjudicative and administrative powers to a common regulatory commission. Model 13 would avoid creation of a two-tier, dual system; but it places the federal government in an awkward minority position from which it can extricate itself only with great difficulty, that is, by withdrawing from

> the integrated system and setting up an independent federal system. Such action would almost certainly result in a lengthy constitutional struggle to determine the respective legislative powers of the federal parliament and provincial legislatures and probably would not gain much public support. As a result, once it agrees to an integrated system the federal government will probably be, in the absence of any crisis, locked into that system. Nonetheless model 13 has a number of desirable characteristics: it permits some federal and provincial autonomy; it tends strongly to statutory and administrative uniformity; it necessarily leads to a common system of information processing; it renders the duplication of facilities unnecessary; it permits more efficient use of experienced personnel; and it permits flexible, decentralized administration at little added cost. (p. 1705)

Table 6 summarizes the suggested advantages and disadvantages of the unitary, dual, and integrated prototypes for a federal presence in the securities area.

My personal view is that if, for whatever reason, the federal government does enter the area, then the integrated approach is the appropriate vehicle. Indeed, even within this approach there are several options. A decentralized version of an integrated approach is what the CANSEC proposal was all about (model 14 of Table 5). As Howard (1979) recognizes:

> It is the requirement of a comprehensive federal securities act that distinguishes model 13 from the CANSEC proposal. The CANSEC proposal is directed at *uniform administration* of a narrow, supplemental federal law and several discrete provincial laws, whereas model 13 is directed at *uniform administration of a uniform law* with a substratum of provincial laws that preserves provincial autonomy with respect to intraprovincial transactions. (p. 1705)

In other words, the federal role under a CANSEC or 'decentralized' version of an integrated approach would be principally one of building on the existing framework, providing a vehicle for more co-ordination and harmonization, and filling in any legislative voids in the interprovincial network.

TABLE 6

Comparison of models for a regulatory system

Characteristics	Model 6 Advantages	Disadvantages	Model 10 Advantages	Disadvantages	Model 13 Advantages	Disadvantages
Federal autonomy	Yes but constrained	No administrative control except to withhold resources	Yes	Dual system	Yes but constrained	Minority position
Provincial autonomy	Yes but constrained	Federal superimposed at least in part re disclosure	Yes	Dual system	Yes but constrained	Threat of federal withdrawal
Political accountability	Yes	Responsibility diffused; therefore accountability attenuated	Yes	Dual system	No	Responsibility completely diffused
Uniform laws and procedures	No	Tends to a dual system	No	Dual system	No but tends to uniformity	Less local experiment-ation
Obviates duplication of regulation	Yes	Tenuous federal control	No	Dual system	Yes	Complicated system to approve change
Makes use of experienced regulators	Yes	Ontario and Quebec dominate	Yes at provincial level	No, particularly regional offices	Yes	

Characteristics	Model 6 Advantages	Disadvantages	Model 10 Advantages	Disadvantages	Model 13 Advantages	Disadvantages
Makes possible central information processing and overall systems analysis	No	Requires co-ordination of discrete provincial files	Yes	Yes, except intraprovincial operations	Yes	
Flexible – decentralized decision making and responsive to local conditions	Yes	Lack of uniformity of standards and procedures	No	Dual system of regional offices	Yes	
Flexible – efficient use of personnel, finances, capital assets	Yes	Ontario and Quebec dominate	No	Almost certain duplication	Yes	

SOURCE: Howard (1979), Table 9.

The series of background studies that contained the papers by Howard (1979) and by Anisman and Hogg (1979) is volume 3 *(Background Papers)* of a major federally sponsored effort (Consumer and Corporate Affairs Canada, 1979). Volume 1 of the study actually contains, in draft form, a full-blown proposal for a Canada Securities Act. From my reading of the draft legislation, it would appear to fall under number 4 of Table 5. The proposed federal legislation ranges across the entire securities field and incorporates a Canadian Securities Commission which would regulate all stock exchanges. While there is provision to accommodate various degrees of co-existence with the current arrangements, this matter is entirely at federal discretion. In the limit, it would appear that the provinces could count only on maintaining jurisdiction over intraprovincial issues. This represents the extreme case, in terms of altering the existing (de facto) distribution of powers. And it may have many proponents.

However, the time has come to assess the need for a greater federal presence in the securities area. I have surveyed some of the literature that has called for federal regulation – from the Royal Commission on Banking and Finance (1964) to the above-mentioned 1979 three-volume study, *Proposals for a Securities Market Law for Canada.* If one were to start from square zero to erect an institutional and legislative framework for an efficient securities market in a federal nation, the existing Canadian approach would not spring early to one's mind. Why five separate stock exchanges? Why no federal securities act? And so on. But it seems to me that these are not the appropriate questions to be addressed. Rather the issue at hand is: how well are the Canadian securities markets working? The answer would appear to be: very well indeed and getting better. At the same time, there are some storm clouds on the horizon. To these issues I now turn.

Two cheers for the provinces

In an era when the provinces are coming under increasing criticism for 'province-building,' i.e., erecting barriers to the internal common market, the securities market area represents a sphere of economic activity where they appear to have performed quite admirably. I am not suggesting that the provinces' actions are motivated solely by national concerns. They probably are not. However, there are

powerful forces at work in the system to ensure some considerable degree of harmonization.

First, the TSE is by far the largest stock exchange in the country. Hence the decisions of the TSE (and the OSC) will naturally have an important (inordinate?) influence on the regulations in other provinces, particularly the smaller ones. As noted above, the options for these smaller provinces are limited. If they want to have a different set of regulations about disclosure, for example, then they will have to build up a qualified staff of experts to deal with the differences among the regulatory systems. For most provinces, these extra costs do not warrant moving too far away from Ontario's practice.

However, suppose that the Saskatchewan securities commission does want to have more strict rules for disclosure. Surely that is its right. This right would presumably exist even if there were federal legislation. After all, the American states have the option of state-specific disclosure rules. Thus a federal presence, such as the SEC in the United States, is no guarantee of uniformity.

Second, our securities markets are very open, i.e., international. Since some company shares are listed on the New York Stock Exchange as well as the TSE or the Montreal Stock Exchange, events in the US system tends to be considered quickly and seriously in Canada. Thus the unfixing of US commission rates in 1975 was followed, albeit with a lag, by a similar deregulation of commissions in Canada in 1983.

Given this openness, if the Canadian exchanges wish to maintain their position as major stock exchanges, they must remain competitive internationally. In turn, this ensures that the stock exchanges will strive to be competitive not only in the national but as well in the international context. A Canadian version of the SEC might attempt to ensure that Canadian-based companies could list their shares only on domestic exchanges. Indeed, there have been some proposals to this effect. Such a situation is hard to imagine (on both constitutional and competitive grounds) under the present system, and in my view this is an important plus for the decentralized approach.

As important, however, are the positive implications arising from competition between the exchanges. Innovations can be implemented by one exchange and will spread across the system if the results are deemed to be positive. Examples are not hard to come by. The

Montreal Stock Exchange (MSE) has recently introduced a new facility in the international currency exchange area. With hookups to various international exchanges, investors can now trade gold options on a 24-hour-a-day basis. Even more important is the MSE's move in the direction of establishing a specialist system of trading. These specialists are designated to trade solely for the purpose of stabilizing markets (i.e., they do not undertake agency trading). As a result, the overall liquidity in the market has been improved and frequently the MSE has better prices than the TSE, with the result that some trading is moving to Montreal. Needless to say, the TSE has recently widened its coverage of future trading. And at the time of writing, both exchanges are in the process of internationalizing markets by establishing even closer contacts and cross-listing with American exchanges.

The likelihood is that these sorts of innovations will intensify as the Canadian exchanges vie with each other and with the American exchanges. Innovation could, of course, take place within a Canadian version of an SEC, but is unlikely to proceed at the same pace. For one thing, the current decentralized approach tends to put an additional premium on developing efficient markets. For another, not all experimentation is likely to be successful. Hence, an argument can be made for a decentralized system in that any initiative will affect only part of the overall market. It would appear that an umbrella organization such as a Canadian SEC (to which all exchanges would report) would tend if anything to strive for uniformity and inhibit innovation by individual exchanges.

It is important to re-emphasize the degree of interprovincial co-operation that is occurring under the existing decentralized system. One such example was in connection with the recent OSC decision to move away from fixed commissions. Naturally, the Ontario commissioners were present at the hearings. But so were the chairman and a commissioner from the Alberta Securities Commission, the superintendent of brokers for British Columbia, and the chairman of the Commission des valeurs mobilières du Québec. In addition, counsel to the Quebec commission participated in the hearing. Hence, when the OSC finally comes up with a decision on a given matter, the other provincial securities commissions are not only normally fully aware of what is going on, but they often have participated in a meaningful way in the decision-making process.

Therefore the question of a major federal presence in the securities legislation area boils down to the issue of the manner in which such a move could enhance the efficiency of the existing securities market. (It should be noted that Ottawa is not entirely absent. Its corporation legislation has an important influence, and the Criminal Code is operative as well.) Some improvements are clearly in order, and a federal role may provide the needed catalyst. However, there is also the downside risk to consider. The move will certainly generate substantial uncertainty, not to mention the likelihood that it will rekindle federal-provincial confrontation. There will almost certainly be an increase in bureaucracy and perhaps two levels of regulatory legislation. Moreover, there will be a very different set of pressures put to bear on such an agency. For example, I would place even money that one of the first moves of a Canadian SEC would be, in name of regional equality, to develop and fund a Maritimes Stock Exchange.

In short, I believe that there is little need for a national regulatory body. Even now, there is at least as much uniformity in Canada as there is in the United States in terms of the preparation of prospectuses. Moreover, there is one very important feature of the present system that is serving the nation very well. The feds can always move into the area if the provinces are lagging in either developing efficient markets or in looking after the interests of investors. This places a very substantial pressure on the various provincial securities commissions to work together. And this is precisely what one would want from a system.

To conclude, it is useful to have a provincial perspective on the operations of the present system of securities regulation. The following are the views of William Pidruchney (1983), chairman of the Alberta Securities Commission:

> The fact is that the federal government has some time ago done studies, drafted a model Act and so forth, and perhaps is ready, willing and able to take over the system. This is an ongoing concern although presently there's not been any particular pressure. I would simply like to make a case for this regulation being left in the jursidiction of the provinces and territories of this country, as it currently is . . . I think we start with the first proposition that I think you won't find too abhorrent, and that is that we certainly do not want a duplicitous system. We do not want a federal and a provincial

or territorial system in place. That's the American experience where they have the SEC and they have state regulation as well. That's too much regulation. I'm going to suggest to you that there is in fact a dynamism in diversity and the provinces and regions of this country are in fact very diverse. Each province in fact does have its own aspirations and it does have its needs, and I think it's entirely legitimate, not only legitimate but actually desirable, that these provincial aspirations and regional aspirations be pursued and met as best possible. And there are some other advantages. There is a freedom of choice to an issuer who wishes to do business in a country wherein there are different jurisdictions. There's the advantage that, should a regulator decide to vary his course and to do something for him to test that option, and there's the opportunity for several jurisdictions to test several options all concurrently. There is the advantage of avoiding total disaster should a whole monolithic system, a unitary system, be derailed. And I'm suggesting that that has happened historically and could conceivably happen again. This way, disasters, if they occur, are localized. There's a greater degree of specialization in all of the regions. Alberta, I think you'll concede, has probably specialized in oil and gas affairs, and oil and gas regulation. And that's logical and that's the type of expertise we need. We need more specialization rather than less. There's a counter-balancing that occurs when all of these regulators in their different modes come together and share their opinions and views. This system of course does lead to some variance and the fact that Quebec has varied in the question of who can be registered as brokers or as brokerage registrants has been raised today. I think this is entirely legitimate. I think it's important for us as members of the same national family to have a perspective on this. While there is a variance at the present time I think it's an interesting and a valid experiment and the effects of that experiment will be instructive to the rest of us. I think that logic and commonsense always do prevail and that the regulators will eventually mainstream on whatever side of the fence they end up. But I think it's important to the structure of our country and to the operation of this country that people have this opportunity.

I would like to assure you of this, the Canadian Securities Administrators of all regions and provinces meet twice a year.

> And they meet expressly for the purpose of sharing views, establishing policies that are national or regional, and the point of the whole exercise is to ensure that enterprise and issuers doing business in this country have the opportunity to do business on a national basis without impedance, hindrance or obstacle. We've coined a little phrase that we say – compatability in all jurisdictions if not uniformity. And I say to you that's our promise to you. I say to the federal government – we have a good system, the system works, if it's not broken don't try to fix it. (pp. 84-5)

The policy environment

Apart from this enduring federal-provincial struggle, there are some important policy issues at stake in the area of market intermediaries.[7] Most of these fell in one way or another under the umbrella of the recent OSC hearings and report (1985) on the regulatory framework relating to entry into and ownership of the securities industry. While the one hundred or so registered securities firms are free to operate in the unregulated (exempt) markets, they do so at a considerable disadvantage, since their competitors are not bound by either their registration or ownership requirements. As Table 7 reveals, this concern has increased over time with the growth of private placements (essentially the exempt market). In response to this situation, Daly Gordon (now Gordon Capital) proposed to set up a separate corporation (in the form of a joint venture with an offshore partner) to carry on the 'exempt' part of its business, thereby ensuring that, in terms of trading in these exempt areas, the proposed new cor poration (Gordon Capital Corporation) could meet the competition on its own turf. Even though Daly Gordon insisted that the new corporation would not withdraw capital from its registered business, the Investment Dealers Association (IDA) and the TSE vetoed the proposal. Largely as a result, the OSC embarked on an investigation into the structure of the Ontario securities market.

While it is unrealistic to attempt to present the full range of concerns in these hearings, there were three pivotal and interrelated issues: the sources and quality of capital that will be available to the domestic securities industry to handle future growth, to innovate, and to compete with other providers of financial services; whether and to

TABLE 7
Corporate long-term debt issues (by type of capital market)

	Private placement ($ million)	Public placement ($ million)	Total ($ million)	Percentage public
1974	717	1,810	2,527	72
1975	581	2,478	3,059	81
1976	764	1,719	2,483	69
1977	1,266	1,876	3,142	60
1978	826	1,647	2,479	66
1979	949	1,219	2,168	56
1980	1,581	1,381	2,962	47
1981	2,030	1,161	3,191	36
1982	1,154	983	2,137	46
1983	1,735	1,167	2,902	40

SOURCE: OSC (1985).

what extent non-resident, institutional, or other non-industry participation in the domestic securities industry is necessary or desirable; and to the extent that outside participation is permitted, how and to what extent should such activities be regulated by the OSC (OSC Bulletin, Jan. 29/84, Vol. 7, #26/84).

The Joint Securities Industry Committee (1984) argued in a background paper prepared for the OSC's hearings that the capital base of the securities industry was adequate, and so no major alteration in ownership restrictions was warranted, and that all firms currently carrying on activities in the exempt markets domestically should be required to register with the securities administrators and to comply with the ownership restrictions that cover registered securities firms. In tandem, these recommendations would signal a dramatic turning inward of the securities industry, moving it in the direction of greater regulation and protection.

In my view, this is precisely the wrong policy direction, particularly at the present time. The name of the economic game today is adjustment and restructuring so that the Canadian economy can regain its competitive edge. Among other things, this implies that

capital be available as cheaply and as efficiently as possible not only to large firms but also to small and medium-sized firms. In this sense the securities industry can and should be viewed not only in terms of its own characteristics but also in terms of an intermediate input into the larger goal of economic structuring. In turn, this calls for an opening up of the industry to greater competition, not a turning inward. Moreover, an opening up of the system is probably vital to the longer-term structure of the industry itself. The force of technology and the increasing globalization of capital markets imply that adopting a protective stance toward the industry will likely lead to a situation where Canadian firms will be relegated to the role of regional brokers in an increasingly international capital market.

These observations lead to one of the central thrusts of the present paper, namely that it is in the securities industry, rather than in the other three pillars, that there is the most need of ensuring competition and innovation. The remainder of this section will attempt to buttress my arguments for opening up the industry, culminating with a brief discussion of the OSC's recent (1985) report on the industry.

Is capital adequate?

Much of the debate in the OSC hearings focused on the issue of whether the capital base of the securities industry was 'adequate.' This became important, since a demonstration to the effect that there was inadequate capital would lead quite naturally to arguments for easing up on the ownership restrictions, foreign as well as domestic. The Joint Securities Industry Committee (JSIC) focused on unused capital-raising potential under the existing rules, arguing that an easing of ownership and capital restrictions was not called for. On the other side of the ledger, the four largest US firms (Merrill Lynch, Salomon Bros., Shearson American Express, and E.F. Hutton) each had a capital base (as of 1982) in excess of the capital base of the entire Canadian securities industry, and Merrill Lynch itself had three times the entire Canadian capital base (Courchene 1984, Table 2). The later analysis dealing with the rising popularity of 'bought deals' can also be used to buttress the capital inadequacy side, since these bought deals require a larger capital base. Moreover, the equity financing of small and medium-sized companies and the provision of risk capital should be a 'key objective in regulatory reform' (Lortie, 1984, p. 16). It is hard to imagine that this too would not call for

greater capital. Finally, the fact that several Canadian securities firms do feel constrained by the ownership restriction ought to carry the day on the capital adequacy issue.

However, even though I believe that it can be demonstrated that the capital base of the securities industry is inadequate, adequacy as such ought not to be the issue. In my view, it is not the role of a regulatory authority to implement policy on capital access on the basis of one or another notion of capital adequacy. Rather, the policy is or ought to be the following: allow maximum capital access or maximum availability of capital subject only to any overriding public interest (Courchene 1984, p. 19). Obviously, I was delighted that the OSC in its report (1985) concluded 'that the basic issue is not adequacy of capital but access to capital' (p. ii).

The burden of proof

Closely related to the manner in which a particular regulatory question is phrased is the issue of where the burden of proof ought to lie. For example, with respect to enhanced capital access, should those wishing a more open securities industry have to demonstrate that this would not be contrary to the public interest, or should those espousing the status quo be required to show that a more open system would be contrary to the public interest? The latter is surely correct, for it places the burden of proof precisely where it ought to be – namely on those that argue for cartelization, protectionism, or impediments to the operations of capital markets.

In this regard, the OSC's recent approaches are exemplary. In the 'Green Line' case the OSC (1983) phrased the issue as follows:

> The Commission determined that the test that it should apply in considering the implications of discount access services should be based on what is perhaps the fundamental principle of any free society: *namely the presumption that any action is permissible unless it can be demonstrated to be contrary to the public interest.* Thus the question before the Commission was: 'Is the offering of discount services by financial institutions prejudicial to the public interest?', rather than 'Are such services in the public interest?' The use of this test reflects the Commission's belief *that free market forces should generally determine the availability of a service and that the four pillars concept is an exception from this view dictated by particular*

circumstances. The public interest requires the Commission to determine whether the offering of discount access services as financial institutions would have an adverse impact upon investor protection so essential to the healthy functioning of our capital markets. (pp. 16-17, emphasis added).

The OSC took this same basic approach in its more recent ownership review (1985):

> We have adopted the unrestricted regulatory environment as our starting point because we believe that as a general matter in our free enterprise system (i) the forces of competition should determine who can act as a market intermediary in the capital markets and (ii) any competitive restriction imposed upon market intermediaries must be well founded in public policy and must be the minimum necessary to achieve that policy. We refer to this approach as our 'free markets approach'. (p. 24)

To be sure, this does not allow the OSC complete leeway in addressing regulatory issues, since it accepts the basic overriding public policy objectives which, in the recent ownership review, it determined to be that it was Ontario government policy that securities firms remain substantially Canadian, and that public policy has decreed that the financial system be organized into four pillars. The Ontario Task Force on Financial Institutions has much more leeway in challenging these public policy objectives should it so wish. Indeed, given the Green Paper proposals, it will have little alternative but to take a position on these issues.

In any event, in both the phrasing of the issue at hand and in the determination of where the burden of proof must lie, I think the OSC has to be congratulated. This is particularly the case since what triggered the hearings in the first place was an attempt by parts of the industry to enhance their ability to innovate and to compete.

Concentration

Arguments relating to concentration have long served as one of the principal ones in favour of restricting financial institutions' ownership of securities firms. With their very small capital base, the securities industry would be easy prey for the large deposit-taking

institutions, or so the argument goes. But consider the so-called 'worst-case' scenario, where the chartered banks would gobble up large parts of the securities industry. As Booth (1982) has pointed out, there would still be enough competition within the sector itself and between the US and Canadian market intermediaries (pp. 20-1). He goes on to note that this would have been a far more likely scenario as a means of circumventing the monopoly prices being charged by the brokerage industries prior to the advent of negotiated commission rates. Now it is much less likely. Indeed, after Britain opened up ownership rules, to the extent that banks moved into the brokerage business, it was generally through setting up their own companies rather than via takeovers.

Further, it is all too easy to view the issue of concentration from the wrong perspective. The accepted perspective is that the banks are too big. I submit that it is far more appropriate to argue that the securities industry is too small. In turn, this is in large measure a result of overly restrictive ownership and investment rules. As Williamson (1979) has noted, one can interpret the initial imposition of ownership restrictions as a stopgap in order to prevent foreign firms from exploiting the undercapitalized Canadian industry until the resident-owned firms could obtain access to new capital (p. 814). However, this window of opportunity was not used to advantage largely because of the overall regulatory environment, and the securities industry continues to be free to raise the concentration banner once again against either or both of foreign or institutional ownership. In my view, concentration is rapidly becoming a vicious circle. Because of ownership restrictions, the Canadian securities industry remains smaller and less capitalized than it would otherwise be. Hence the industry can continue to fall back on concentration to support the maintenance of limitations on ownership. Now is the time to break through all of this and to move forcefully to allow substantially freer access to capital.

The irony is that the securities industry may have been too successful in its ability to preserve Ontario's ownership restrictions. One reason why the Green Paper allows holding companies to acquire securities firms (provincial legislation permitting) may be that Ottawa has lost patience with these protectionist provincial measures.

Conflicts of interest

Conflicts of interest exist in all pillars. The very essence of the securities industry involves a potential conflict of interest between dealers and brokers. The way that this conflict of interest is handled is through the OSC's registration requirements, which ensure professionalism. The industry's argument appears to be that this professionalism can be maintained only if it is accompanied by ownership restrictions. As far as non-industry, non-financial ownership is concerned, I find it difficult to believe that there is something peculiar to Ontario that requires that our securities firms can be owned only in 10 per cent tranches. Does Merrill Lynch lack professionalism? The implicit assumption would appear to be that outside owners would lower firms' professional standards without, for example, compensating elsewhere, such as lowering the price of services, so that the viability of the firm is put in doubt. This does not attribute much rationality to the outside investor – he or she is assumed to take those sorts of actions that will undermine the value of his or her investment.

Rules must and do exist to prevent abuses of conflict of interest. If these rules are effectively policed, then there is no reason to add the additional restraint on the ownership of securities firms. To be sure, Ontario legislation requires that securities firms remain substantially Canadian, and so the OSC can go only so far in opening market intermediaries to foreigners. But there is no such constraint on domestic ownership. The Ontario four-pillar policy requires separation of functions, not restrictions on ownership. In other words, financial separation is not necessary for functional separation.

Competition and efficiency

One of the stated goals of regulation is to foster competition and efficiency. I would take it as axiomatic that these concerns are essentially synonymous with opening up capital and investment avenues. Both individual investors and the enterprise sector are progressively going to demand the same sorts of services domestically that they know they can get internationally. This is perhaps best exemplified by the growing importance of the 'bought deal'. Once a client has experienced the 'security and speed of a "bought deal" where he knows precisely, in a volatile market, that he has achieved a desired price, he never really feels comfortable going back to the

quasi-agency style of underwriting that is the Canadian domestic norm' (CIBC 1984, p. 11). In the same document, the CIBC (London) points out that 'arguably one of the substantive reasons for the failure of the Canadian securities industry to seek a major role in international capital markets has been their inability to generate a sufficient capital base to enable them to perform this role' (p. 11).

Table 8 elaborates on this point by presenting a sample of selected Canadian borrowers in the Euro Market, showing their principal lead managers. I draw three implications from this table. First, there is a market that Canadian securities firms can gain access to if they are given more freedom to operate. Second, the securities affiliates of chartered banks (Orion and CIBC) are likely to increase their already substantial role in international placements vis-a-vis registered securities firms or their affiliates unless there is more access to capital for the latter. Third, and most important, unless the registered firms are given more room to manoeuvre, I predict that Canadians will eventually demand that companies such as Orion and CIBC be allowed to operate freely in the domestic market. The notion, implicit if not explicit, in the JSIC approach that one can separate the domestic market from the international one is, in my view, inherently wrong. Allowing firms the freedom to freewheel offshore is not the same as ensuring that they can provide the appropriate range of activities to the domestic market. For example, it will become progressively harder to maintain top personnel, since the domestic industry will not be able to provide the exciting environment that a full-service international firm will. We are moving toward one integrated world capital market. Turning inward and ignoring this fact may well result in the domestic industry being overwhelmed by the Orions and CIBCs of this world.

As a final comment on ownership restrictions, their impact on the regulated sector leads to two observations. First, firms are at present owned primarily by their employees, who suffer from having a substantial part of their wealth tied up with the fortunes of one industry. Second, securities firms are at present at a disadvantage relative to financial intermediaries and to foreign and exempt-sector market intermediaries in that they are essentially forced to finance their growth from the internal resources of their owner-managers. I find Professor Booth's analysis (1982) of these points difficult to improve upon:

TABLE 8

A sample of selected Canadian borrowers in the Euro Market showing their principal lead managers

Borrower	Lead manager	Currency ($)
Government		
Government of Canada	Deutsche Bank	US
Province of British Columbia	Deutsche Bank	US
	Swiss Bank Corporation	Cdn
Ontario hydro	Deutsche Bank	US
Province of Manitoba	Wood Gundy	US
Province of New Brunswick	Credit Suisse First Boston	US
Province of Newfoundland	Credit commercial de France	US
Province of Nova Scotia	Union Bank of Switzerland	US
Province of Quebec	Warburg/Credit Suisse First Boston	US
Hydro Quebec	Warburg/Credit Suisse First Boston	US
	Merrill Lynch	Cdn
Province of Saskatchewan	Credit Suisse First Boston	US
EDC	Credit Suisse First Boston	US
	Wood Gundy/Orion	Cdn
FBDB	Wood Gundy	US/Cdn
Farm Credit	Goldman Sachs	US
	Wood Gundy	Cdn
Canadair	Merrill Lynch/Morgan Guaranty/CIBC	US
Selected corporates		
Alcan	Morgan Stanley	
	Swiss Bank Corporation	
Bell Canada	Union Bank of Switzerland	
Canadian Pacific	Orion/Swiss Bank/Goldman Sachs	
Gaz metropolitain	Wood Gundy	
Gulf Canada	Morgan Grenfell	
Hiram Walker	Morgan Guaranty/Warburg	
Hudson's Bay	Morgan Stanley/CIBC	
Imasco	Wood Gundy	
Inco	Morgan Stanley	
Loblaws	Orion	
Pan Canadian Petroleum	Orion	

TABLE 8 (cont'd)

Borrower	Lead manager	Currency ($)
Royal Trustco	Wood Gundy	
Seagrams	Wood Gundy	
Shell Canada	Morgan Stanley	
Simpson Sears	Wood Gundy	
TransAlta	Merrill Lynch	
Trizec	Merrill Lynch	
George Westons	Hambros	
Xerox	Orion	

SOURCE: CIBC (1984), Appendix A.

> By restricting public ownership of the securities industry to those who are employed in it, you force upon them the holding of an extremely undiversified securities portfolio. Not only is their human capital, or career, tied up with the securities industry, but so too is the bulk of their personal wealth. The basic proposition of finance is that expected return or profit on an investment is a function of the riskiness of that investment. By not allowing diversification of their wealth, through public ownership, it is to be expected that profits within the securities industry are higher than they would be if the investors in that industry could diversify their wealth and thus reduce the risk to which they are exposed. The profits within the industry are increased via higher commission rates or wider bid-ask spreads in the dealer market, both of which reduce the operating efficiency of the Canadian capital markets. Restrictions on public ownership and diversification thus create operational inefficiencies. These can best be reduced by public ownership. (pp. 26-7)

A menu of options

In the range of options for the securities industry, one might include the following in order of increasing access and competition:

1 The JSIC model, which would maintain ownership and capital requirements for registered firms and also apply these to the present exempt market.
2 The status quo.

3 The status quo à la Gordon Capital, which would allow registered firms to joint-venture freely in the exempt market.
4 Model 3 plus a substantial opening up of the registered sector in terms of ownership restrictions.
5 The unfettered market, with no ownership restrictions anywhere, but registration re professionalism.

From the above analysis it should by now be obvious that I view option 4 as the minimum acceptable reform.

The OSC report

The OSC report (1985) recommended the following changes in the ownership and regulation of the Ontario securities industry:

1 *Investment by non-residents:* Non-residents may own (singly or in combination) up to 30 per cent of a registered securities firm. However, if non-residents in the aggregate own more than 10 per cent of a securities firm, then the firm must have one significant industry investor owning in excess of 50 per cent of the participating and voting securities (presumably via a holding company).
2 *Investment by financial institutions*: Same as 1.
3 *Investment by others:* Same as 1, with one important exception. 'Others' can own up to 49 per cent in the aggregate.
4 *Universal registration and ownership requirements for the core function:* Only registrants will be able to act as underwriters, and full service brokers – i.e., the present exempt-market operations – will have to cease.
5 *Foreign dealer registration:* There is a new category of registration – foreign dealer registration – for firms owned more than 30 per cent by non-residents. There will be a limit imposed on the aggregate capital of this category (30 per cent of the industry total) and on the capital of each firm (1.5 per cent of the industry capital). In effect, this would be the securities industry equivalent of the Schedule B banks for the banking sector.
6 *Grandfathered non-resident firms:* They will be registered as foreign dealer registrants but may be assigned capital limits in excess of the 1.5 per cent allowable for other foreign dealer registrants.

For the previously regulated sector, this plan represents a considerable easing of ownership and capital restrictions. The downside cost is that the previously exempt markets now fall under regulatory supervision and the new ownership restrictions. Overall, this is sort of a halfway house - an easing up on the regulated sector and clamping down on the unregulated or exempt sector. The latter development represents, in my view, a retrograde step, particularly as this sector was leading the way in innovation. In terms of foreign ownership, the OSC was no doubt influenced by the Ontario policy of maintaining Canadian ownership of securities firms. However, there is a sleeper in the recommendations. While the foreign dealer registration requirements appear restrictive, these foreign dealers will have the name and expertise of their parent firm to draw on. Hence, they may enhance competition much more than their capital limitations would suggest. In turn this will generate further pressures to open up the domestic regulated sector.

Naturally, there are many (e.g., presumably, the JSIC) who no doubt feel differently about the OSC report. Indeed, since the OSC recommendations must be accepted by the Ontario government before they can be implemented, battles will probably be fought anew at this level. However, the Green Paper's proposals, particularly the provision whereby financial holding companies can (provinces willing) acquire securities firms, will likely significantly alter the environment of any future proceedings with respect to ownership. The fact that in principle a foreign-dominated, federally regulated holding company would be permitted (by Ottawa) to acquire a securities firm might be cause for concern about the restrictive nature of Ontario's policies in this area. Those in favour of restricting foreign ownership are probably best advised to level their sights on the Green Paper rather than at the OSC regulations. For if Ottawa adopts a more open system and if some provinces follow suit, it will be very difficult for Ontario to maintain a more restrictive stance. These observations apply to the other categories of ownership as well. In short, it appears to me that the pressures on Ontario to open up the securities industry have been intensified substantially by the Green Paper. Or perhaps more correctly, just as for deposit-taking institutions, the Green Paper has created both a sense of urgency and a frame of reference for the market intermediary aspect of the hearings of the Ontario Task Force

on Financial Institutions. I am optimistic that the momentum is now clearly with the forces of competition and innovation.

VIII CONCLUSIONS

The purpose of this paper has been to review some of the many jurisdictional and policy issues relating to the operations of the Canadian financial services sector. By way of summary, let me offer the following observations:

1 The role of the financial sector is to facilitate the transfer of savings from lender to borrower. Hence, regulatory authorities must be careful not to place inordinate attention on the structure of a particular sector at the expense of overall allocative or operational efficiency. In this context the conclusion of the OSC report (1985) is worthy of note:

> Our task is not to exercise our powers to protect any particular group of participants in the capital markets. Our responsibility is to create a structure which encourages the efficient operation of the capital markets. (pp. 65-6).

2 Relatedly, regulation serves both a policing function and a planning function. In terms of the latter, it is critically important that any so-called overriding public policy objectives for the financial sector not be in conflict with the economic imperatives of the 1980s and 1990s, namely efficiency, flexibility, and adjustment. This would be my choice of the overriding public policy objectives that ought to drive the 'planning' aspect of financial regulation.

3 At the broadest level, there do exist competing paradigms relating to the underlying structure of financial systems and the manner in which the financial system interacts with the process of economic adjustment. While it is useful to be aware of the other models and to draw from them when necessary, it seems to me that we have no choice but to continue with the capital-markets, competitive-pricing approach to industrial finance. This being the case, it is imperative that our capital markets become as efficient and accessible as possible. This is doubly important since, in my view, the domestic securities industry is currently the weakest of the four pillars.

4 The internationalization of capital markets, the force of technology, and developments south of the border are among the many factors leading to financial integration (i.e., leading to the erosion of the four pillars). Money is so inherently fungible and capital markets are so international that it is not obvious that regulation can do much to offset the underlying trends elsewhere in the world financial sector. Nor should they!

5 The current jurisdictional (federal-provincial) regulatory overlap is such that this process of financial integration is almost sure to intensify. In particular, Quebec's regulation-by-function approach lends official sanction to financial integration.

6 Enter the federal Green Paper. Canada now has three competing models for the financial sector, or, more particularly, for the relation between financial and market intermediaries. Ontario's approach amounts to functional separation as well as ownership separation. The Quebec model embodies functional integration. The Green Paper model attempts to preserve the four pillars (functional separation) but, via the holding company route, permits ownership integration even to the point of allowing the commercial sector to own both financial and market intermediaries.

7 The implications of the Green Paper for commercial lending (i.e., for banking) are quite dramatic. In the limit, banks need no longer be widely held. The underwriting and banking functions will be able to be combined (via a holding company). And the traditional commercial and banking separation will be eliminated.

8 One interpretation of what the Green Paper is all about is that it recognizes that it is too late to turn the clock back on narrowly held financial intermediaries and on the concept of financial holding companies. Hence, far better to 'lean with the wind' in these developments and attempt to provide an overall structure within which these ongoing developments can be more easily monitored and perhaps be given some direction.

9 Another interpretation of the Green Paper is that Ottawa is cleverly using the federal power over banking or commercial lending to attempt an 'end-run' on provincial regulatory powers. I am not very enthusiastic about this development, since provincial

control over the securities industry has served our nation well. For policies to be national, they need not be central.

10 However, there are genuine concerns about ownership and capital requirements in the securities industry. For both individual investors and the enterprise sector there is a need to provide for an insurgence of capital into market intermediaries. With some degree of presumption, it is also my view that this would be in the interest of the securities industry itself. Operating under a protective regulatory cover in the face of mushrooming technology and the globalization of markets is likely to relegate the domestic industry to the category of 'regional' brokers in a world environment.

11 The OSC's report on ownership was, in part at least, a step in the right direction. There is now more freedom to operate in the regulated sector. However, the elimination of the exempt market represents a disconcerting development.

12 In this context, the Green Paper's proposal that a holding company can own a market intermediary may be a most welcome catalyst. Even the industry itself may now recognize that the nature of the underlying issue is not whether more competition is needed but rather how much and how fast.

13 At a more detailed level, it seems to me that enterprises should be able to gain access to a domestic equivalent of the Orions and CIBCs of this world. It is ironic that the types of services that the chartered banks can provide overseas are not available domestically. In my view, unless the OSC and its counterparts elsewhere open up the securities sector, Canadians will demand that the Orions and CIBCs be allowed to operate domestically.

14 Continuing with the role of banks in the system, it may be appropriate, as suggested in the Green Paper, to hold the banks back in order to allow the rest of the system a head start – equity and perhaps even efficiency (i.e., the 'infant industry' argument) would call for a temporary levelling of certain players. But if we are talking about the likes of Trilon and Power Financial, then there is no rationale at all to 'short-chain' the banks.

15 This brings me full circle. These summary notes began with a plea that efficiency and innovation take precedence over concern about structure. This can be phrased differently. In several of the pillars, Canada has world-class institutions. Regulatory reform must ensure that ten years from now those institutions remain world class and that the rest of the system strive for this as well. Such a goal should be uppermost in any regulatory reform. And it must be with respect to this goal, rather than to any details of financial structure, that such planning regulation as the 'short-chaining' of banks ought to be assessed.

16 Finally, and more generally, it may well be that we all are prone to put too much emphasis on both the set of regulations and who does the regulating. I believe that there is a certain inevitability as to what the structure of the financial system will be like in the 1990s. It will have more to do with the computer revolution, with the demands of consumers, and with the evolution of the financial industry internationally than it will with the particular set of regulations Canada puts in place today or whether these regulations are federal or provincial. This is long-run economic and technological determinism, as distinct from the institutional, constitutional, or regulatory determinism that may hold sway over the shorter term. In this longer term, what will likely decide whether Canada's financial institutions serve our consumers well or attain world-class status will not be this regulation or that regulation but whether the nation as a whole maintains an overall economic climate that is inviting and exciting as a place to innovate and do business.

APPENDIX: THE STRUCTURE OF THE SECURITIES INDUSTRY

The purpose of this appendix[8] is to provide background relating to the structure of the securities industry in Ontario. There exist both a regulated and a non-regulated sector. I shall deal with each in turn.

Regulated sector

There are approximately 100 securities firms registered under the Ontario Securities Commission (OSC) that are members of the Investment Dealers Association of Canada (IDA) and/or any of the five Canadian stock exchanges. These registered firms are subject to two general sorts of regulation: registration requirements and ownership restrictions.

Registration requirements

The Securities Act (Ontario) contains the following general provisions about registration:

1 Those who trade in securities must register as dealers.
2 Those whose trading involves the distribution of securities as principal or agent must register as underwriters (actually, registration as a broker-dealer, investment dealer, or securities dealer under (1) is deemed registration as an underwriter).
3 Those who advise as to investing in securities must register as advisers.

In addition to some bonding and capital requirements, registration typically involves adherence to certain professional requirements – e.g., education – and adherence to rules about knowing your client, suitability for investment, and disclosure.

Ownership restrictions

There are ownership or capital restrictions with respect to both foreign and domestic investors in the regulated securities market. On the domestic side, no single non-industry investor can hold voting securities carrying more than 10 per cent of the voting shares of the firm. In addition, at least 40 per cent of the directors or partners of a securities firm must be industry members. Non-residents in the

aggregate cannot hold more than 25 per cent of any class of securities, and no single non-resident investor can own or control more than 10 per cent of any class of securities. This is frequently referred to as the 25-10 provision.

The non-regulated sector

One of the rationales for regulating the securities industry is to protect the investing public from such things as fraud, inadequate disclosure, and conflict of interest. However, the regulatory authorities have long recognized that there are certain classes of securities and certain classes of agents for which concerns about such problems as disclosure and fraud are not likely to loom important. These have come to be referred to as the 'exemptions' under the Act, or as the 'unregulated' aspect of the securities market.

In general, there are two general types of exemptions. One applies to certain classes of securities where the very nature and quality of the instruments (e.g., government bonds) are such that there is really no need for registration requirements in order to protect the investing public. The other relates to the nature of the participants themselves. The argument here is that registration on grounds of protection, full disclosure, etc. is not needed for trades that involve sophisticated and knowledgeable investors who are quite capable of independent analysis of the merits of any investment.

Exempt trades

The Securities Act provides that no registration is necessary in some 23 specified trades. For example, there is an exemption for trades involving certain financial institutions and governments. The rationale for granting such an exemption is that the financial institutions are regulated by their own governing statutes and that financial institutions and governments are presumed to have the expertise and sophistication to determine, for themselves, the merits of their investments.

The Securities Act also provides an exemption from registration for trades to companies and persons recognized by the commission as exempt purchasers. Exempt purchaser status is intended primarily for those institutions with substantial pools of capital and sophisticated investment advisers, such as financial institutions that are not

licensed to do business in Ontario and professionally managed pension and mutual funds.

By far the most controversial of the exempt trades is what is referred to as private placement. The Securities Act provides an exemption from registration where the purchaser buys as principal and where the security has an aggregate acquisition cost of not less than $97,000. The rationale for this exemption is the presumed sophistication of an investor with this amount of money available for investment. The increasing number of after-the-fact announcements of securities issues that appear on the financial pages (referred to as 'tombstones') bears witness to the importance of this exemption.

Exempt securities

The second category of exemption relates to certain classes of securities. Registration is not required for trading in bonds and debentures (direct or guaranteed) by the various levels of government in Canada or foreign countries, various financial institutions, and development banks. Short-term negotiable promissory notes or commercial paper in denominations greater than $50,000 are also exempt. Once again the rationale is one or more of the following: the issuers are regulated in their own right; the nature of the instruments is such that there is no need for the protection afforded by registration; or the purchasers (for commercial paper, for example) are thought to be sufficiently sophisticated and knowledgeable to evaluate the investment.

Thus, a considerable portion of the domestic market in securities is unregulated.

Cross-national markets

Finally, much of the international trading is also unregulated. Non-resident firms may deal in Canada in exempt securities, and they may also deal with exempt institutions in any other securities. Moreover, many Canadians (individuals and institutions) currently have accounts with non-resident securities firms for trading in foreign markets. This activity is also unregulated, at least by the OSC.

NOTES

Joel Fried, Clyde Goodlet, and Bob Young provided valuable comments on an earlier draft. The views expressed are my own, and not necessarily those of the Ontario Economic Council.

1 Two other important federal documents – the deposit insurance review and the technical overview relating to the Green Paper – were not as yet published when the final version of the present paper was submitted.
2 Many of the government agencies listed below probably have counterparts in the Unites States. To the extent that this is the case, the difference is principally one of degree.
3 Provincially chartered trust companies and mortgage loan companies are regulated by the provinces. Federally chartered trust companies are governed by the Trust Companies Act, and mortgage loan companies are governed by the Loan Companies Act, both of which are supervised by the federal Department of Insurance. However, such federally chartered companies need, in all provinces, licences from provincial authorities to operate them. Moreover, some of their trust activities are governed by federal legislation, despite their federal charter. This note is adapted from the Green Paper (Government of Canada 1985, p. 59).
4 From the Green Paper:

> The credit unions and caisses populaires provide a useful example of the rather accidental fashion in which the existing regulatory system gained its shape. Early in its history, the caisse populaire movement sought federal charter. A lack of favourable response by the federal government led the movement to then seek provincial charter and recognition for locals. Later, however, the federal government enacted the CCAA (Co-operative Credit Associations Act), under which the CCCS (Canadian Co-operative Credit Society) gained its charter. Subsequently, six provincial centrals found it in their interest to register under the CCAA and have thereby become subject to supervision by the federal government. (p. 60)

5 In the case of deposit insurance, provincial institutions that are insured must meet federal standards but are still supervised by provincial authorities. Some provinces, however, have arranged to have the federal Department of Insurance supervise the financial institutions incorporated in their province.
6 Substantial parts of this section are adapted from Courchene (1985).
7 This section borrows heavily from Courchene (1984).
8 This appendix is adapted from Courchene (1984).

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Comments

Charles Freedman

I would like to focus most of my comments on the financial intermediary aspects of Tom Courchene's interesting and provocative paper. In particular, my comments are aimed at extending Courchene's parts II and III – the rationale for financial intermediation and the rationale for regulation of financial institutions. The reasons for concentrating on these underlying fundamental questions are, first, that I believe that it is impossible to understand recent regulatory developments without having a clear idea of the goals of financial institution regulation and how they have been achieved in different countries; and, second, because Courchene does not, in my view, treat these issues in sufficient depth.

RATIONALE FOR FINANCIAL INTERMEDIATION

Let me begin with the rationale for financial intermediation. Courchene begins with Gurley and Shaw (1960), which is a useful starting point. Unfortunately, with the exception of some references to Shearer, Chant, and Bond (1984), he does not go much further than Gurley and Shaw. In the last few years there have been a number of analyses in the literature that have gone beyond the early insights and have attempted to take into account recent developments in areas such as agency, information, and signalling theory. In my discussion I rely heavily on a survey and extension of this literature that Professor John Chant is preparing for the Bank of Canada.

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What are the important stylized facts about deposit-taking financial intermediaries that one wishes to explain? In my view, there are two stylized facts that are crucial for understanding the nature of deposit-taking financial intermediaries as they have developed in Canada, the United States, and the United Kingdom. First, these institutions hold variable-price assets and issue fixed-price liabilities; and second, a high proportion of the assets on their books are not easily marketable. Thus banks and trust companies, for example, hold mortgages, personal loans, and business loans, all of which have some risk of default associated with them and, to a great extent, are not traded in secondary markets. But they issue fixed-price deposit liabilities which, except in the case of insolvency, pay out returns not related to the returns on the assets of the institutions.

Now there are other financial institutions that are not structured in this way. For example, mutual funds relate the return on their liabilities to the return on their assets. Thus, a reduction in the value of their asset-holdings is translated immediately into a corresponding reduction in the value of their liabilities. Clearly, diversification, which is the principal function of mutual funds, can be achieved without issuing fixed-price liabilities.

Nor are such matters as maturity transformation nearly as fundamental as we used to think. Indeed, today, the emphasis in Canadian institutions is on match-funding – if the mortgage borrower wants a five-year term for his or her mortgage, the institution will generally look for a corresponding five-year deposit to fund the mortgage. And relative rates on one-year and five-year instruments will adjust to bring the demand and supply of funds at each term into balance unless the institution is deliberately willing to take a gamble on interest rate movements.

What then explains the nature of deposit-taking financial institutions in Canada? I think that the answer can be developed by considering a more fundamental question. What can a financial institution do for the ultimate lender and/or ultimate borrower that these transactors cannot do for themselves? Or, to put it another way, why are the ultimate lender and borrower willing to pay the intermediary to stand between them? In some cases the answer is straightforward. Payment intermediaries provide transferable instruments that are not otherwise available. Life insurance companies issue life insurance, and pension funds issue rights to future pensions. In the

case of both life insurance companies and pension funds, much of the institution's portfolio is in the form of market instruments such as bonds and equities, but the ultimate investor cannot hold these bonds and equities directly and still obtain the life insurance and pension elements that the institution can offer.

In contrast, most of the portfolio of banks or trust companies is not in the form of marketable instruments such as bonds, equities, or treasury bills. There is no reason why a lender should pay the deposit-taking intermediary a premium for investing in an asset he could buy himself either directly or through a mutual fund. It follows that the crucial element in the portfolio of the deposit-taking financial intermediary is that it holds in large part non-marketable instruments that require both initial credit assessment and continuing evaluation and monitoring. Thus the ultimate lender is prepared to pay the bank or trust company an intermediation margin for holding a mortgage or personal loan because he is not willing or able to undertake the credit assessment himself. Nor is he able to ensure that the investment is monitored appropriately over the life of the loan.

In passing, I note that this aspect of financial structure may change over time with the development of mortgage-backed bonds and mutual funds for mortgages as well as secondary markets for commercial and personal loans. In a world with these types of instruments and markets, there would be greater reliance on market intermediation and less on institutional types of intermediation. We already see this happening in the United States, where mortgage bankers initiate mortgage loans and package them for sale to individual investors. Also, the movement to off-balance-sheet types of instruments in the United Kingdom may result in the increasing importance of direct finance, albeit with financial institution guarantees on the instrument in order to minimize lender risk.

The nature of bank portfolios thus relates to the role of banks as assessors and monitors of credit risk. Why does this necessarily imply the kind of fixed-price deposit structure we find in our deposit institutions? There are two possible answers to this question. First, in a world where the probability of default of the ultimate borrower can fluctuate over time and in which there are few or no secondary markets to price the value of existing loans, it would be extremely difficult if not impossible to set up a bank in mutual fund form. That is, mutual funds rely upon an explicit secondary market to price their

assets (e.g., equity or money market mutual funds), or, as in the case of mortgage funds, they calculate the present value of the stream of payments which is guaranteed by a public or private insurer – e.g., the Canada Mortgage and Housing Corporation (CMHC) and the Mortgage Insurance Company of Canada (MICC). Neither of these conditions holds for the bulk of a bank's portfolio. Second, one can argue that if banks are allowed the residue between the value of their variable-price assets and that of their fixed-price liabilities, they will have an incentive to devote the appropriate amount of resources to the continued monitoring of their loans. That is, the banks will increase the resources devoted to monitoring loans until the marginal dollar so spent will yield only a dollar in loan recovery. Thus, this structure deals very effectively with the so-called agency problem, namely, how can the depositor ensure that the agent who is monitoring his or her loan is spending an appropriate amount of resources on this activity?

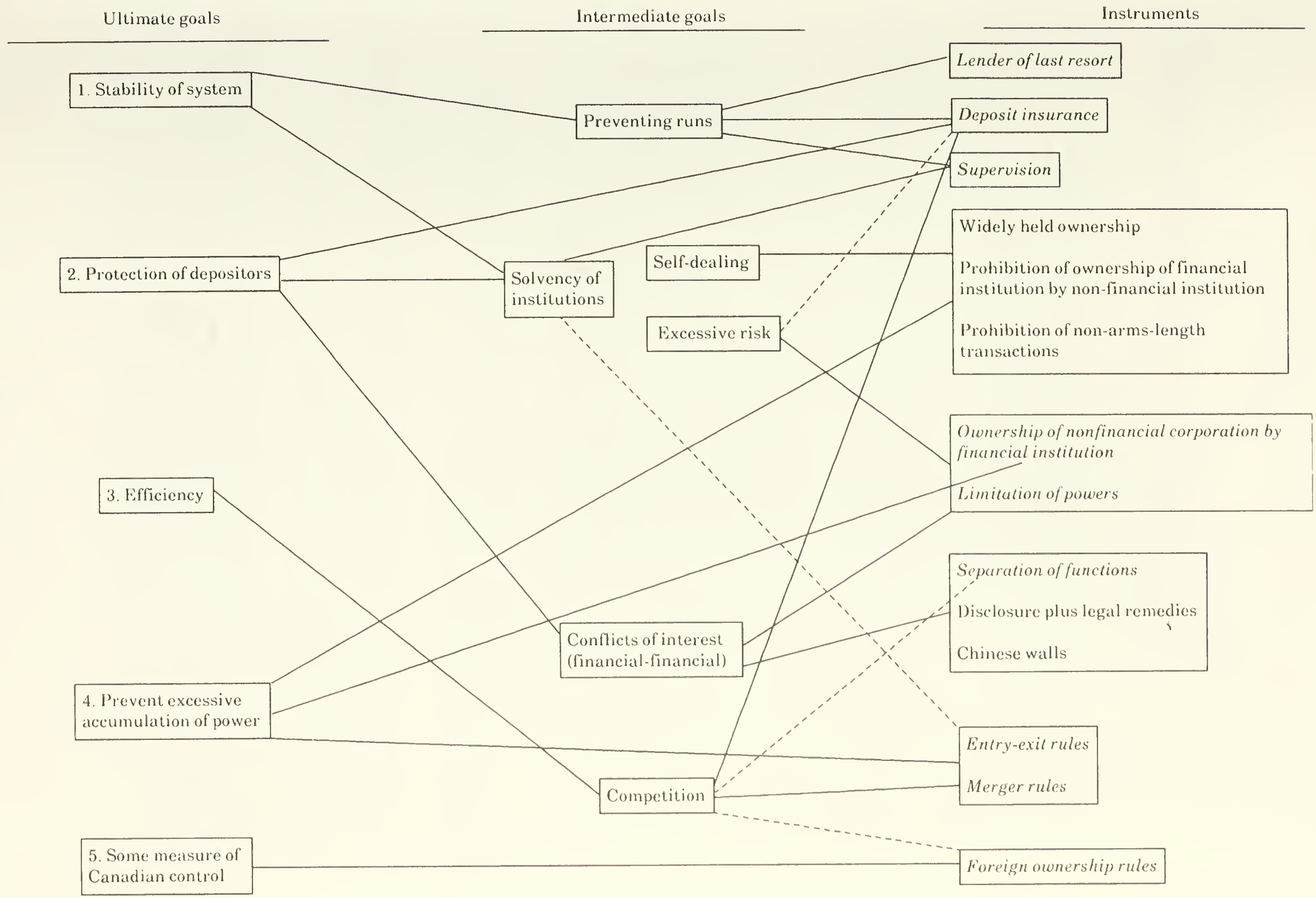
RATIONALE FOR REGULATION

The second major item I wish to address is related to Courchene's part III – the regulatory rationale. I think that Courchene does not treat this issue in sufficient depth, and I propose to try to expand upon his discussion. After outlining my views on the goals of regulatory policy, I will try to explain why financial institutions are regulated differently from non-financial businesses and then to discuss the instruments used to achieve these goals in Canada and elsewhere. One point worth making in advance is that Courchene, like many others, does not always distinguish carefully enough between the goals of policy and the instruments of policy. I will argue, for example, that the so-called four pillars structure is not an object of policy but simply a means to a goal.

In Figure 1[1] the ultimate goals of policy are presented in the left-hand column, and the instruments potentially available to the authorities to achieve those goals are laid out in the right-hand column. In the centre column are listed what I call the intermediate goals, which are the means whereby the ultimate goals can be achieved but which are not instruments – they are not the techniques used by the authorities to achieve their objectives. The solid lines connecting the items in the figure represent the positive links between the various elements in the scheme, and the dashed lines represent harmful side-

FIGURE 1

Goals and instruments in the regulation of financial institutions



effects that can result from the use of a given instrument. Note that most instruments impinge on more than one goal.

Goals for regulatory policy

In most countries there appear to be three principal ultimate goals of regulatory policy in the financial sector:

1 *Stability of the financial system.* The terms soundness, confidence, and integrity are often used in this connection. There must be a widespread belief that the financial system is sound if it is to function properly both as a payments system and as an efficient allocator of savings.

2 *Protection of depositors.* Normally the focus here is on protecting unsophisticated savers against the possibility of loss resulting from failure of financial institutions.

3 *Efficiency in satisfying customer preferences.* This includes both the classical static notions of efficiency and more dynamic notions. Included in the former are production at least-possible cost and pricing to reflect costs. That is, the value of resources used in the 'production' and 'delivery' of financial instruments should be minimized, given the available technology. Also, the price charged for a financial product should reflect only the costs of production and delivery plus a normal profit. The more dynamic notions include the optimal introduction of new techniques of production and delivery.

In addition, in some countries attention is paid to two other goals that are of less importance:

4 *The prevention of excessive accumulation of power.* This is basically a political notion, not an economic notion.

5 *Some measure of domestic control over the financial system.*

I now turn to the intermediate targets that stand between the ultimate targets and the instruments used by the authorities to achieve the goals. (The number in brackets refers to the relevant ultimate goal.)

Prevent runs (goal 1): In order to ensure the stability of the financial system, one would want to avoid or at least minimize the effects of runs on deposit-taking institutions. This is sometimes termed avoiding contagion effects, i.e., the spillover of concern from institution to institution as doubt is cast on the viability of all or a class of financial intermediaries.

Solvency of financial institutions (goals 1, 2): In addition to the concern about runs on the system as a whole, there is also concern about the solvency of individual institutions. In part, this is related to the more basic concern about maintaining confidence in the system; in part, it is related to the concern about protection of depositors. There are two elements that come under this heading: the prevention of self-dealing and the avoidance of excessively risky investments. While this intermediate target does not imply that institutions should never be allowed to fail, it does suggest that, because of the importance of the financial system, there is a desire to avoid the kind of failure that would weaken depositors' confidence in the stability of the system. For example, evidence of self-dealing will raise doubts about the safety of other institutions in the minds of depositors. Similarly, if one or more financial institutions became insolvent because their investments were, *ex ante*, excessively risky, doubts might arise about the soundness of similar institutions. Once deposit insurance is introduced as a way of avoiding runs, regulations must be added regarding the degree of portfolio risk that will be tolerated. Otherwise, some institutions would tend to invest in an excessively risky portfolio, since the potential gain from such an investment would accrue to shareholders and a substantial part of any loss incurred would be absorbed by the taxpayer or the customers of depository institutions through deposit insurance pay-outs.

Avoidance of conflicts of interest (goal 2): I use the term conflict of interest to refer to financial-financial conflicts, in which the interests of one customer are harmed to the benefit of another customer or the benefit of the institution itself, as opposed to issues of self-dealing. Most of these fall under the rubric of principal-agent conflicts. They can be harmful to the customer of the financial institution but, unlike self-dealing, will not endanger the solvency of the institution. Hence the concern regarding this type of activity derives mainly from the desire to protect the customer of the financial institution.

Competition (goal 3): The goal of efficiency in satisfying customer preferences can be achieved by the maintenance of a reasonable degree of competition in various markets. Note that one should assess competition by markets (e.g., consumer loans, personal deposits, business loans), not by classes of institution.

Why financial institutions are regulated differently

Having set out the goals, both ultimate and intermediate, of regulating the financial system, I can now go on to analyse the differences in the regulatory treatment of the financial industry and of the non-financial industry.

At first glance, it would appear that there is an enormous difference between the treatment of the two kinds of industries. Thus, the behaviour of financial institutions is constrained by a panoply of regulation and supervision, whereas that of non-financial corporations seems to be almost completely unconstrained. On closer examination, however, the differences are not quite as great as appear on the surface, and those important differences that do exist are related to two factors – first, the difference in the goals that the authorities are trying to achieve in the two sectors, and second, the difference in the nature of the institutions which requires that even where the goal is the same it must be achieved by different means.

In general, if one were to draw a flow chart of goals and instruments for the nonfinancial sector similar to that in Figure 1 for the financial sector, it would have efficiency as its first goal and protection as its second goal. It is possible that some measure of Canadian control and avoidance of concentration of power would also be included. However, there would be no goal corresponding to stability of the financial system, and, as will be seen shortly, in most cases protection is a less important goal in the non-financial sector than in the financial sector and is typically achieved in a different way in the non-financial sector. It is these differences – the absence of system stability as a goal, the lesser emphasis on consumer protection, and the different means by which this protection is achieved – that are crucial in differentiating the two sectors as far as regulatory treatment is concerned.

Consider first the question of system stability. As noted earlier, doubt about its soundness can harm the financial system. Thus what the public had thought to be liquid, sight assets can become illiquid claims if the institution cannot meet demands for withdrawal. Also, if

the banks are forced to call loans and sell off collateral, the result could be a significant decline in asset prices. This would cause other collateral to fall in value, thus triggering further calls of loans and might ultimately result in a severe debt-deflation process. More generally, loss of confidence in the financial system might lead to reduced intermediation and compel a greater use of direct finance. To the extent that some borrowers cannot engage in direct finance or can use direct finance only at higher costs, there would be a loss of efficiency in the process of transforming savings into investment.

The significance of system stability in the financial sector accounts to a large extent for the degree of regulation of those institutions that issue sight or very short-term deposits. In contrast, these considerations appear to play no role in the non-financial industry.

In dealing with the question of protection of the user of services, there is not quite as sharp a distinction between financial and non-financial business. Rather there is a continuum in which some areas are more regulated and others are less regulated. For example, there are securities regulations that impinge on all companies that are issuing bonds or shares to the general public and that are designed to prevent certain types of behaviour in order to protect the investor. Similarly, certain kinds of behaviour are defined as fraudulent, whether carried out by financial or non-financial companies. And both company law and criminal law impinge on various aspects of the behaviour of both kinds of organizations.

Nevertheless, in general there are differences in the treatment accorded to most financial companies and that accorded to most non-financial companies, and these lie in the nature of the constraints imposed and the type of regulation. For most non-financial companies, a combination of disclosure and access to legal remedies is considered sufficient to deal with most kinds of misbehaviour. For example, attempts to convert company funds to the use of a principal shareholder will be treated as fraud (a criminal offence) and will also be subject to civil suits by minority shareholders. The interests of bondholders are protected by the restrictive covenants normally associated with bond issues, which set out certain kinds of behaviour that are not permitted to the borrowing company. If the company contravenes the covenantal restrictions, the bond falls due immediately and the bondholders can sue the company to collect their funds. By and large, the system of control on non-financial companies is one of *ex*

post reaction to certain types of unacceptable company behaviour (remedial regulation, in Chant's terms).

In contrast, the system of controls on most financial institutions is one of *ex ante* prevention of certain kinds of behaviour (preventive regulation, in Chant's terms). Thus, for example, there may be regulations regarding the kinds of assets they hold or the kinds of liabilities they issue. And there are supervisors to ascertain that the companies are complying with regulations.

Why is there this difference between the two groups of companies? It appears that there is an implicit cost-benefit analysis that underlies the different approaches to the two kinds of institutions. That is, the potential cost to society from using remedial controls on financial institutions rather than preventive controls is deemed to be greater than the benefits that might derive from such a change. A principal reason why the costs are so much higher in the case of financial companies derives from three characteristics of their balance sheets – their assets are much more fungible than those of non-financial companies, they have a much higher leverage ratio, and there is deposit insurance on the bulk of their liabilities. The significance of fungibility is that it is much easier to misappropriate the assets of a financial institution than the fixed capital of a manufacturing firm. Because of the high leverage ratio, the owner of a financial firm may find it extremely profitable to run his firm into bankruptcy by making 'bad' loans to companies with which he is associated. In the case of a company with a 25-to-1 leverage ratio, his loss of capital would be 4 per cent of the assets (or less if he is only the majority owner), whereas his gain may be many times this amount. Because of deposit insurance, depositors have less incentive to monitor the behaviour of the financial institution and are less concerned about the behaviour of the management. If we were to use only *ex post* lawsuits as a means of dealing with fraudulent or questionable behaviour, there might be no assets left to attach and the losses might be extremely large because of fungibility and the high leverage ratio. Further, the existence of deposit insurance and a widespread belief that the authorities would not permit a large financial institution to fail would ensure that there would be very little ongoing monitoring of the company by depositors.

Historically, the primordial or fundamental factor leading to preventive regulation must have been the fungibility of assets. Once preventive regulation and supervision were imposed on the financial

sector, the perceived safety of financial institutions was enhanced and leverage ratios were permitted to rise, in turn accentuating the need for preventive regulation. When deposit insurance was introduced, the role of preventive regulation became even more important.

Another factor differentiating some financial companies from non-financial companies is the greater difficulty of evaluating the financial companies' assets. Since many of these assets are nonmarketable and since they turn over so rapidly, there is considerable difficulty in evaluating a financial company's worth on an ongoing basis. This is particularly the case for a small depositor, since the size of his or her investment cannot justify the time and expense of such an evaluation. The failure of a financial institution may be more damaging than that of a non-financial institution in one other respect: many small depositors may hold all their financial assets with that one company.

In sum, in the area of protection, there are a variety of reasons why there is more regulation in the financial sector than in the non-financial sector and why most of it is preventive rather than remedial. However, there are also cases in the non-financial sector where the consequences of errors or of questionable behaviour are considered potentially very serious – e.g., in the testing of drugs – and in such cases, regulation in the non-financial sector has also been preventive rather than remedial. Thus, there is no sharp distinction of principle differentiating financial from non-financial sectors under the heading of protection, but rather an implicit evaluation of costs and benefits of differing types of regulation.

I conclude that the combination of the system stability arguments in the financial sector plus the more stringent requirements for protection in the financial sector than in most parts of the non-financial sector accounts for the generally different treatment of the two sectors from the standpoint of regulation and supervision.

INSTRUMENTS OF REGULATION

Returning to Figure 1, I now address the right-hand column, i.e., the instruments of regulation. Different countries have achieved the goals of regulation by different combinations of instruments. Instruments used in Canada in the past are italicized in the figure.

Canadian authorities have relied on:

– Deposit insurance and the lender-of-last-resort facility to prevent runs.

– Widespread ownership of financial institutions to minimize problems of self-dealing.

– Supervision and a variety of limitations on types of permitted investments and on lending powers to deal with the problems of excessively risky portfolios.

– Separation of functions to cope with financial-financial conflicts of interest.

– Merger rules to deal with efficiency and concentration-of-power concerns.

– Limitations on foreign ownership to maintain a degree of domestic control of the financial sector.

Over the past twenty-five years, an increasing amount of attention has been devoted to efficiency concerns and the need to increase competition in various financial markets. In the main, this has been achieved by giving increased powers to the various financial institutions, a development that has led to a considerable amount of penetration into each other's markets (e.g., personal loans, mortgage loans, deposit markets). In addition, certain types of anticompetitive behaviour were made illegal (e.g., collusion among banks, cross-ownerships of certain types), and interest-rate ceilings on bank loans were removed. Also, entry requirements for chartered banks were eased, and the introduction of deposit insurance facilitated the ability of small institutions to compete with larger institutions for deposits.

I am not suggesting that historically these instruments were introduced with these goals clearly in mind. Nonetheless, over time, they have come to play the role indicated in Figure 1. Thus, widely held ownership of banks, mutual insurance companies, and, until a few years ago, trust companies came to be seen as a key factor in preventing self-dealing. Similarly, the so-called four pillars, which, in some circles, have come to be seen as a goal of policy, have principally played the role of preventing financial-financial conflicts of interest. For example, the potential problems of allowing the same institution to make commercial loans and to administer trust funds were dealt with by forbidding banks to administer trusts and limiting the

commercial lending that could be done by trust companies. Likewise, the separation of banking from the securities industry avoids a variety of potential conflict-of-interest problems.

Now it is clear from the experience of other countries that there are other ways to achieve the goals of financial regulation. For example, the British and Americans permit banks to do trust business and deal with the problem of potential conflicts of interest by requiring a Chinese Wall between the two parts of the business. Other countries try to avoid problems of self-dealing by limitations or restrictions on transactions rather than by ownership rules. Thus, the American authorities have complex rules regarding 'upstream lending', and the British have both limits on and special rules regarding 'connected lending'. In some cases, what appear to us to be potential problems seem to be ignored, as in the combination of underwriting and banking in West Germany. In other cases, what we ignore in Canada is seen as a potential problem in other countries, as in the recently abolished requirement for single capacity (i.e., separating brokering, dealing, and underwriting) in the British securities industry. Such differences derive from different historical patterns and, to some extent, from empirical judgements as to whether certain risks are sufficiently serious to warrant some form of regulation. More accurately, the benefits from regulation in terms of avoidance or limitation of problems have to be weighed against the costs of regulation in terms of lessening the ability of financial institutions to operate efficiently.

Two recent tendencies in the Canadian financial structure have made it clear that the system of instruments used in Canada in the past will no longer suffice to achieve the goals of regulatory structure. First, there has been growing interpenetration by industry groups of each other's traditional market sector. That is, there has been a tendency over time for each industry grouping to try to enter into what had earlier been the preserve of other industries, typically while trying to protect its own area from increased competition. In the most recent period both the speed with which such developments are occurring and the intensity of the pressure for change have increased markedly.

The other important development has been the spread of the conglomerate movement to the financial sector. Owners of a financial institution in one industry have gained control of institutions in other

financial industries, and, in addition, non-financial firms have been purchasing financial firms. For example, some trust companies and life insurance companies have been brought under common ownership and, in most cases, are closely held. This tendency has upset two long-standing traditions in the Canadian financial sector: first, that the ownership of financial institutions has usually been widely held, and, second, that financial institutions have largely been independent of major non-financial interests. At the same time, other recent developments have made policy makers more concerned about the potential for self-dealing and have made it essential to find a new instrument to deal with the self-dealing problem for closely held firms.

The recently issued Green Paper can be seen as a way of coming to terms with these developments. To the extent that two of the traditional means of coping with self-dealing and financial-financial conflicts of interest, namely widespread ownership and institutional separation of functions, are no longer as pervasive as they were in the past, different means have to be found to deal with these problems. The Green Paper proposes a system that would try to prevent self-dealing by severely limiting non-arm's-length transactions between affiliated financial and non-financial companies. To deal with the problems of financial-financial conflicts of interest, the establishment of Chinese Walls and a system of increased disclosure plus the enhancement of civil remedies is proposed. Although some of the details remain to be worked out, what is absolutely clear is that the regulatory system will have to adjust to cope with the current and prospective changes in the financial structure.

NOTES

1 The figure and some of the following discussion have been taken from C. Freedman, 'Recent Developments in the Structure and Regulation of the Canadian Financial System,' to be published in the volume of proceedings of the Société Universitaire Européenne de Recherches Financières (SUERF) Conference, 'Shifting Frontiers in Financial Markets,' held in Cambridge, England, March 1985.

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Comments

James C. Baillie

Professor Courchene's paper makes the distinction between 'policing' and 'planning' as regulatory objectives. The paper clearly demonstrates that the issues raised by the Green Paper go beyond policing to include important planning implications. Whether or not one agrees with him that implementation of the Green Paper might move the Canadian financial system toward universal banking on the German model, the fact that such a comment can be made illustrates the potential significance of the Green Paper.

I do not propose to attempt an analysis of the Green Paper, or to comment in detail on Professor Courchene's remarks. To my mind, the current proposals illustrate certain characteristics of policy making in commercial-financial aspects of Canadian law. I propose to use my available time by outlining these characteristics, as I perceive them, and noting how they are illustrated by the Green Paper.

I should emphasize that the characteristics are not limited to legislation affecting financial institutions. Legislation on combines, insolvency, and intellectual property has similar characteristics. In all of these areas of our law, desirable – even essential – changes have been long delayed. In brief, the characteristics of which I speak are fourfold.

1 There is the quest for a perfect model. We seem reluctant in the commercial-financial area to proceed with change on an incremental basis to deal with clearly identified problems. Rather, we prefer to

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postpone action until an overall pattern of legislation has been identified and attained consensus. Because economists (as distinct from lawyers) are so influential in our decision-making process, this means that the model must be supported by the economic community or a significant part of it.

2 Traditional economic models have a major impact on the formulation of legislative proposals. Unfortunately (to my mind) those models often seem to be premised on a larger economy than that of Canada and do not give full weight to Canadian policy objectives of a non-economic nature. Further, economic concepts such as the market discipline provided by 'poised competition' may be less relevant in Canada's markets than elsewhere because we have more limited resources and economies of scale are more difficult to attain.

3 There is frequently an assumption that perceived difficulties in legislative implementation of an economic model can be met by regulation. As a former regulator, I am acutely aware of the fallible nature of regulation and that it is often a less than adequate tool to assist in the implementation of an economic model.

4 The models, when developed, frequently give rise to problems of federal-provincial relations. The constitutional structure in the financial-commercial area is such that these problems arise with frequency, particularly when a new legislative regime is proposed. When they do arise, they frequently create controversy that further lengthens a legislative process that would, in any event, be protracted because of other considerations. Even the last revision of the Bank Act – a statute clearly within federal constitutional authority – was affected by debate arising from federal-provincial considerations.

Before commenting on these points in the context of the Green Paper, I should stress that I am not criticizing the proposals in that paper. They constitute a carefully considered model for the operation of Canada's financial institutions. The model may well be a desirable one. My concern is that the nature of the proposals is such that implementation may prove to be a protracted process – as it has been with corresponding proposals in other areas of the law.

Turning to aspects of the Green Paper that illustrate the general points I have made, the proposal for Schedule C banks is illustrative of the problems involved in the quest for a perfect model. Discussion in

the Green Paper indicates that this proposal is driven largely by concern with the allocation of commercial lending powers to trust companies. Frankly, the proposal seems to me an over-reaction to that concern, although there may well be other policy objectives underlying the proposal.

At the risk of being inconsistent with my comment that the Green Paper reflects a quest for an overall model, the omission from it of a treatment of existing Schedule A and Schedule B banks seems to me troubling. They have a far-ranging impact in our system; I question whether reform of the system can be effectively attained without reference to those banks.

My concern with the tendency for policy formulation to be based on traditional economic models appears to have been shared, at least to some extent, by the authors of the Green Paper. The discussion of 'short term swamping' – the possibility that larger institutions might assume dominance in a deregulated environment – indicates recognition that economic theory does not fully operate in a smaller economy. However, other aspects of the Green Paper seem to give more weight to traditional models. In particular, the suggestion for greater international involvement by the Canadian securities markets emphasizes the prospect that this will lead to Canadian institutions carrying the flag in other countries, but there is no discussion of the significance of institutions from other countries carrying their flags to Canada.

As to reliance on regulation, the Green Paper clearly contemplates a more active regulatory involvement. The discussion of Chinese Walls is particularly interesting. I recognize the merits of Chinese Walls, but one must be specific as to what activities are located on each side of the wall. The background papers recently published by the Department of Finance identify five examples of activities that may give rise to conflicts within a financial complex:

- Commercial lending and securities-related activity.
- Commercial lending and the management of trusts.
- Securities-related activity and the management of trusts.
- Deposit-taking and the management of trusts.
- Underwriting and securities distribution.

I cannot believe that it would be effective to require five separate Chinese Walls, separating each of these activities.

As to federal-provincial relations, Mr Freedman comments that the draftsmen of the Green Paper did not intend that it operate to expand federal power. Despite this assurance, it seems clear that the holding company proposal will be interpreted in this way. The resulting controversy seems to me likely to have a delaying effect.

In closing, let me register a plea. Perhaps the new government will be prepared to give the Green Paper proposals sufficient priority to ensure their passage. If experience demonstrates that this is not feasible within a reasonable time period, my plea is that the government instead proceed with the incremental changes that are needed to deal with problems that have been clearly identified and on which consensus or near-consensus exists. These problems are serious, and their resolution is urgent.

PART II: CONSTITUTIONAL ASPECTS OF CHANGE

The changing regulatory environment for Canadian financial institutions: constitutional aspects and federal-provincial relations

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The constitutional jurisdiction to regulate financial institutions in Canada is divided between the federal and provincial orders of government. That much is clear. But what is far from clear, even now, is the precise boundary line of that division. Perhaps that should not be too surprising, since the Constitution itself does not supply a clear theoretical basis for drawing such a boundary. In the end, however, the usual difficulties inherent in any attempt to suggest what changes in the Constitution might produce a better result – in this case, a better regulatory environment for Canadian financial institutions – are compounded by the uncertainties that flow from any attempt to provide a clear picture of the necessary starting point for constitutional change: the current state of the federal-provincial division of powers. We will try, nonetheless.

In this paper, we will approach our task in three stages. The first section will explore the theoretical bases for federal and provincial jurisdiction over Canadian financial institutions, concentrating on the sources of constitutional authority available to the two orders of government under the heads of power set out in sections 91 and 92 of the Constitution.[1] The second section will discuss the federal-provincial regulatory framework that has developed over the years for our different types of financial institutions, focusing on the ways in which

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the present regulatory framework reflects its origins in the sources of constitutional authority discussed in the first section. Finally, the third section will set out the options that we see as being realistically available should those charged with making such decisions conclude that either the sources of constitutional authority or the federal-provincial regulatory framework, or both, should be rearranged.

SOURCES OF CONSTITUTIONAL AUTHORITY

Several approaches could be taken to an examination of the sources of constitutional authority that pertain to the regulation of Canadian financial institutions. One approach, and perhaps the most obvious, would be to discuss in turn each of the so-called four pillars – banks, trust companies, insurance companies, and securities dealers – that are said to comprise our financial community, pointing out the extent to which each pillar stands within federal or provincial jurisdiction. But that approach could be misleading, for several reasons. For one thing, there is far more to the Canadian financial system than is represented by the four pillars; one need think only of the significant role played by credit unions and caisses populaires to see the point. As well, whatever analytical value the four pillars concept might once have had may now be rapidly fading as the pillars themselves move, or are forced to move, into a new era of competition and potential conflict. Finally, undue emphasis on the various financial institutions as an analytical centrepiece can obscure consideration of relevant heads of federal and provincial jurisdiction that could be brought to bear upon those institutions. Accordingly, this part will concentrate on the roots of federal and provincial legislative authority in the constitution itself – on the sources of constitutional authority available to the two orders of government in relation to financial institutions.

The discussion will focus first upon the available head of provincial authority, which would seem to be the more general and pervasive in this area. The more specific heads of federal authority will then be examined. This is not, of course, the approach that is suggested by sections 91 and 92 themselves, as they appear on their face to treat the authority of Parliament as general and overriding and the authority of the provincial legislatures as specific exceptions to that federal authority. And it may well be that the Fathers of Confederation intended the federal presence to be predominant here; Professor (as he then was) Bora Laskin suggested, for instance, that section 91 'con-

tains overwhelming internal evidence of the conviction that money, banking and credit (in its public aspect) should be exclusively of federal concern.'[2] But as the courts have developed the relation between sections 91 and 92 over the years (and not in this area alone), provincial authority has assumed a general residuary character that seems to pervade the field, with the various heads of federal authority operating in essence as exceptions to, or subtractions from, that provincial authority.[3] So it seems more appropriate to consider first the sources of that provincial authority, and then to turn to the more specific heads of federal authority.

Sources of provincial authority

Of all the potential heads of power available to the provinces under section 92 in respect of financial institutions, one stands out above all others – the power in section 92(13) to legislate in relation to 'Property and Civil Rights in the Province.' Indeed, this capacity has been described by Professor Peter Hogg as a head of power 'of great extent and importance' and as 'by far the most important of the provincial heads of power.'[4] As developed by the courts, and particularly by the Judicial Committee of the Privy Council, section 92(13) has come to be seen as the primary source of provincial authority with respect to business undertakings carried on within the provinces. Other heads of provincial authority might also be invoked, of course; the provincial incorporation power under section 92(11) is a good example. And specific heads of federal authority can operate so as to remove from the scope of provincial powers under section 92(13) either a particular class of business (such as banking under section 91[15]) or an aspect of business transactions in general (such as interest under section 91[19]). But in the absence of special considerations of these kinds, it is section 92(13) that gives the provinces their pervasive role in regulating the conduct of business transactions within their boundaries.

The reasons for the pervasive influence of section 92(13) are not hard to discern. Most business transactions are conducted by means of contracts of one kind or another. Indeed, within the financial community it is hard to see how business could be transacted at all except through contractual mechanisms. As long ago as 1881, in the earliest of the insurance cases, it was settled that 'the power to regulate by legislation the contracts of a particular business or trade' rests with the provinces under section 92(13).[5]

The history of the insurance cases has been well documented elsewhere,[6] and need not be duplicated here. Suffice it to say that repeated attempts by the federal government to regulate the insurance business as such, under a variety of heads of power in section 91, all foundered on the rock of section 92(13). Even as late as 1969, the Supreme Court of Canada narrowly upheld (by a 5-4 majority) the application of the federal Winding-Up Act to an insolvent insurance company, under the federal insolvency power in section 91(21); the four dissenting justices would have held even that to be an improper intrusion by Parliament into the provincial domain![7]

A federal presence in the insurance industry is maintained, of course, as it is with respect to loan and trust companies. But that presence depends on heads of power (the federal incorporation power, for example) that are limited in scope and thus do not pertain directly to matters relating to the conduct of business itself. Whenever the transaction of financial business depends on contracts entered into within a province, then the principal jurisdiction to regulate the conduct of that business as such is vested in provincial legislatures under section 92(13).

As with the insurance pillar, so with the rest of the financial sector. With the single exception of banks (as will be discussed in more detail below), the conduct of business by all segments of the financial community is a matter that falls primarily within provincial jurisdiction by virtue of the contract-regulation powers in section 92(13). The business of loan and trust companies is included within the scope of this power, even when those companies are federally incorporated,[8] as is the business of such provincial creations as credit unions and caisses populaires, and even when the business regulated includes deposit-taking activities that might, in some contexts, appear more like a banking business.[9] In the securities industry, provincial authority under section 92(13) was first upheld in 1932[10] and was confirmed by the Supreme Court of Canada as recently as 1982 in a case in which the insider trading provisions of the Ontario Securities Act were held to apply to a federally incorporated company in the face of virtually duplicated provisions in the federal company law regime.[11] The courts have even upheld provincial authority where securities contracts spanned provincial borders. For instance, the Supreme Court of Canada held that Quebec regulatory requirements apply to a Quebec securities dealer whose transactions were restricted

to clients outside the province (outside Canada, in fact),[12] and the Manitoba Court of Appeal held that Manitoba regulatory requirements apply to an Ontario securities dealer who solicited transactions with Manitoba residents by mail and telephone.[13] Accordingly, the mere fact that a financial business may be carried on in more than one province does not detract from the regulatory authority of the various provinces in which that business is conducted, an authority that is theirs by virtue of section 92(13).

Of course, section 92(13) is not the only source of provincial authority relevant to the regulation of financial institutions. Another of particular note is section 92(11), the provincial power in relation to 'The Incorporation of Companies with Provincial Objects.' The power to incorporate a company is not just the bare power to bring it into existence; rather, an incorporation power 'also authorizes all laws of a company law character, for example, the laws pertaining to corporate powers, organization, internal management and financing.'[14] Obviously, then, the authority of a province to regulate a particular financial institution will be enhanced if, in addition to regulating its business conducted within the province, the institution is also incorporated under the laws of that province and thus is subject as well to its company law jurisdiction.

But the incorporation power, especially at the provincial level, is of lesser importance for the regulation of financial institutions than is section 92(13). As will be discussed further below, federal companies enjoy some degree of immunity from provincial laws of general application, such as those that might be enacted under section 92(13) to regulate the conduct of a particular financial business in a province. But there is no similar immunity for provincially incorporated companies that wish to do business in a province other than the one in which they are incorporated. Outside the incorporating province, recognition even of the corporate existence of a provincially incorporated company, let alone of any specific attributes with which it might have been invested by its home province, subsists solely at the sufferance of the other provinces in which that company may wish to do business.[15] Those other provinces may – or may not – decide to recognize the corporate entity, and may decide to recognize it only upon the satisfaction of conditions as to the manner in which it will conduct its business within the host province.

Accordingly, a province cannot use its incorporation power under section 92(11) to invest its creations with corporate power and capacities that are immune to the regulatory measures of other provinces enacted under section 92(13). By the same token, however, each province may exercise its regulatory authority under section 92(13) upon the corporate creations of the other provinces without having to consider any special rights that those creations may claim under the laws of their home provinces. An Ontario-incorporated trust company, for example, carries no special status with it if it is allowed to carry on its business in British Columbia. The power – and, indeed, the responsibility – to regulate the conduct of that trust company's business in British Columbia rests with British Columbia under section 92(13).

In sum, then, the principal – and overriding – source of provincial authority with respect to financial institutions is section 92(13). That head of power may be supplemented by others, notably the provincial incorporation power under section 92(11). But authority in relation to 'Property and Civil Rights in the Province' is so pervasive in scope that it is useful to view it as the bedrock source.

A number of heads of federal power limit provincial jurisdiction. However, in the absence of a specific head of power that has the effect of transferring a matter of financial regulation to federal jurisdiction, the authority to regulate financial institutions is founded on section 92(13) and thus falls within provincial jurisdiction under our present constitutional arrangements.

Sources of federal authority

As we have indicated, a literal reading of section 91 suggests that the Fathers of Confederation envisaged vesting in the federal government powers at least as extensive as those conferred on the provinces. However, this is not the way the Privy Council and the Supreme Court of Canada have construed the division of powers between the two levels of government, and for the most part they have placed a very restricted meaning on the heads of power in section 91 and treated them as subtractions from the provincial power in section 92. This is particularly true of the 'Peace, Order, and good Government' clause in section 91 and of the trade and commerce power in section 91(2).

One of the obvious subtractions from provincial power is section 91(15), the federal power to legislate in relation to 'Banking, Incor-

poration of Banks, and the Issue of Paper Money.' The federal power to regulate the business of banking under section 91(15) is of particular significance as a subtraction from the general provincial power to regulate financial businesses under section 92(13). As was noted above, the strength of section 92(13) as a business-regulation power for the provinces flows from the fact that contracts and contractual relations entered into within the provinces are within its ambit. Financial businesses, dependent as they are upon contractual mechanisms, fall within the provincial authority under section 92(13) equally as much as any other business sector. If not for section 91(15), then, banking would likewise lie within provincial jurisdiction. As it is, section 91(15) reserves to Parliament the authority to regulate the business of banking as such, and correspondingly subtracts that authority from provincial powers under section 92(13).

But if the fact of this subtraction is clear, its scope certainly is not. It is one thing to say that banking as a business activity falls within federal authority; it is quite another to construct a comprehensive and universally acceptable definition of what constitutes a banking business.

In 1893, for example, the Privy Council suggested that banking is 'an expression which is wide enough to embrace every transaction coming within the legitimate business of a banker.'[16] But in 1980, the Supreme Court of Canada expressly rejected a literal reading of the Privy Council's view, on the ground that it was never intended that Parliament have exclusive legislative authority over all transactions that include 'the borrowing of money or the lending of money, with or without security, which come within the legitimate business of a great many other types of institutions as well as of individuals.'[17] In 1981, Professor Ian Baxter had this to say about attempts to define a banking business:[18]

> A bank is allowed to engage in and carry on business appertaining to the 'business of banking'. This phrase is not defined in the [Bank] Act and indeed a precise definition is hardly possible. Probably the intention of the Legislature was to authorize all these activities which the Canadian business world would generally regard as being within the sphere of banking. Presumably, the clause is not meant to authorize any business which a bank chooses to undertake, but on the other hand commercial opinions as to the proper sphere for

> banking may vary in these days of heavy competition between banks, and also with the arrangements in the Bank Act to permit the entry of foreign banks. There have been a number of cases in which the meaning of 'banker' (or 'banking business') has been discussed, but it cannot be said that these have resulted in a precise and simple definition.

In its 1980 decision, the Supreme Court of Canada also suggested that it was, instead, the 'hard core of banking' that lawyers will usually try to define.[19] Even that narrower focus has not proved particularly fruitful, however. Take, for instance, these two passages from a 1949 decision of the Manitoba Court of Appeal (which held, incidentally, that a provincial law empowering a provincially incorporated trust company to accept deposits did not trench upon federal authority in relation to banking):[20]

> The business carried on by most banks includes the totality of the functions I have enumerated, but, of course, a banking business can be carried on without performing all of them and most corporations and individuals engaged in a financial business of any kind are required to carry on or perform some of them, and it does not follow from the fact that banks perform them that every exercise of one or more of the functions is a form of banking.

> Banking is not a technical or legal term but a loose popular one, comprehending activities carried on by those who, likewise popularly, are called bankers. Of these activities some are often and some are usually carried on by bankers. Some are essential to the conception. But very few are exclusive activities of bankers. Chequing privileges accorded to depositors, and general dealing in credit, are characteristic of and perhaps essential to banking. But even that does not make them exclusive rights of bankers, even in the absence of prohibition by statute against others carrying them on.

Professor Baxter concluded:[21]

> There are indeed certain fundamental operations which are consistently regarded as pertaining to banking. These are (1) taking money from the public on deposit, (2) the issue, payment and collection of cheques. However, these activities,

> though they may constitute a *sine qua non* for classification of a concern as doing retail banking business, are not really helpful.

In fact, in its 1980 decision the Supreme Court of Canada seemed ultimately to despair of ever arriving at a satisfactory functional definition of banking. Instead, it reverted to a formal, institutional test to hold that the business of a federally incorporated trust company could not be considered a banking business because the trust company in question was not a chartered bank governed by the Bank Act.[22] This approach is appealing at first glance, because it can represent a simple test to apply: banking is what bankers do, and bankers are those who are defined as such by Parliament in the Bank Act. But the very simplicity of this test would give Parliament a unilateral power to define the scope of its own legislative authority under section 91(15) – and, by definition, the unilateral power also to define the scope of provincial legislative authority under section 92(13) – by the simple expedient of amending the Bank Act to expand the business of the banks into hitherto nonbanking fields.

The federal power in relation to the incorporation of banks, which is also contained in section 91(15), adds little to the resolution of the uncertainties in the scope of federal authority. Like any incorporation power, the federal power to incorporate banks also carries with it the legislative capacity to regulate the internal affairs of a bank relating to company law. It also precludes the incorporation of banks by the provinces.[23] But an incorporation power, on its own, has little significance with respect to the business carried on by the corporate entity once it has come into existence. In this regard, the power to regulate the business of banking – whatever scope the term may have – is of far more significance than is the power to incorporate banks.

Parliament possesses another incorporation power, however, and in relative terms that power is of somewhat more importance than the bank incorporation power. Because section 92(11) limits the provinces to the incorporation of companies 'with Provincial Objects,' it has long been held that the power to incorporate companies with objects that are not provincial rests with Parliament. Originally, it was considered that this general federal incorporation power (particularly the power to authorize federal companies to carry on business throughout Canada) arose from the general power of Parliament in relation to the regulation of trade and commerce under section 91(2).[24] More

recently, it has been suggested that the federal incorporation power rests in the residual aspect of the general federal power to legislate for 'the Peace, Order, and good Government of Canada' (known as the POGG power).[25] Whichever it may be, the federal incorporation power does give Parliament the right to regulate the corporate affairs of non-bank financial institutions that are federally incorporated (a right it requires in the case of banks because of its express power in relation to banking as a business activity).

It is by virtue of the federal incorporation power, as exercised in relation to federally incorporated trust, loan, and insurance companies, that a federal presence is maintained in the regulation of the corporate activities of these kinds of financial institutions. Presumably, such a federal presence could also be asserted with respect to federally incorporated securities firms should Parliament choose to do so.

But there are substantial limits to the influence that Parliament can bring to bear on these institutions under its incorporation power. For one thing, no provincially incorporated financial institution can be touched under the federal incorporation power. For another, the regulation of corporate activities under the federal incorporation power cannot spill over into an attempt to regulate indirectly the business activities of federal companies conducted within the provinces. It is well established that federally incorporated companies enjoy a degree of immunity from provincial legislation, but that immunity extends only so far as to protect their corporate status and essential capacities from substantial impairment by the provinces in the exercise of their general business-regulation authority under section 92(13).[26] The fact of federal incorporation does not protect a federal company from provincial laws that regulate its business activities but stop short of an impairment of corporate status.[27] As the Supreme Court of Canada said in 1976, in holding that a federally incorporated insurance company was not thereby shielded from a provincial law preventing it from continuing its automobile business in British Columbia:[28]

> Parliament can create and maintain the legal existence of a corporate entity, with which a Province cannot interfere. But a provincial Legislature within its own field of legislative power can regulate, in the Province, a particular business or activity. The fact that a federally-incorporated company has, by federal legislation, derived existence as a legal person, with

designated powers, does not mean that it is thereby exempted from the operation of such provincial regulation. It is subject to such regulation in the same way as a natural person or a provincially-incorporated company.

Aside from whatever role it may play as a foundation for the federal incorporation power, the federal authority under section 91(2) in relation to the regulation of trade and commerce has at least the potential for a significant federal presence in the regulation of certain of the business activities of non-bank financial institutions, whether incorporated provincially or federally. The insurance cases, among others, clearly establish that Parliament has no authority under section 91(2) in relation to contractual transactions that take place within the provinces.[29] That jurisdiction rests with the provinces under section 92(13), and seems to extend even to transactions that span provincial boundaries.[30]

But it is also clear, particularly from the long line of cases dealing with the validity of provincial commodity marketing schemes, that Parliament has the exclusive jurisdiction under section 91(2) to regulate transactions that are 'in pith and substance' interprovincial rather than intraprovincial.[31] In the securities field, for instance, parliament could use its authority over interprovincial trade and commerce to regulate at least those aspects of securities dealings, in a market that seems increasingly national in scope, that are truly interprovincial or international in the sense that they are not confined to the boundaries of any one or more of the provinces.[32] However, Parliament's authority under section 91(2) in relation to interprovincial and international trade and commerce would not likely be sufficient to supplant in its entirety the general provincial authority under section 92(13) to regulate the broad spectrum of financial transactions that would remain essentially intraprovincial.

Classically, of course, the federal trade and commerce power was thought to include not only extraprovincial trade and commerce but also the 'general regulation of trade affecting the whole dominion.'[33] In 1978, Professors Philip Anisman and Peter Hogg suggested that this general trade and commerce power might be invoked to support a national plan for regulating securities markets in Canada, over and above the support available under the extraprovincial trade aspect of section 91(2).[34] Some justification for this suggestion can be found in a 1976 decision of the Supreme Court of Canada, in which the Court

struck down a federal prohibition (enforceable by civil action) against business practices that were 'contrary to honest industrial or commercial usage in Canada.' The ruling hinted that the general trade and commerce power might have saved the prohibition had it somehow formed part of a federal regulatory scheme administered by a federal agency.[35] However, the Supreme Court may have subsequently buried the trade and commerce power in a pair of 1979 cases in which it struck down federal regulatory schemes with respect to product standards that seemed truly to be aimed at general trade and commerce in a national sense.[36] The classical doctrine may yet be resurrected – in a 1983 decision, for instance, a substantial minority of the Court, in a concurring judgement, suggested that the general trade and commerce power might provide a foundation for some aspects of the Combines Investigation Act, a statute that for many years had been thought to rest almost exclusively on Parliament's criminal law power under section 91(27).[37] Whether the process of resurrection will continue is problematic, however, and until the ghost of the general trade and commerce power attains more substance in the eyes of the Supreme Court, it is unlikely to provide much reassurance to Parliament as a secure footing for a broadly based regulatory framework for all types of financial institutions in Canada.

At one time, it was thought that POGG might also be available to address regulatory matters that were of 'national concern' or had attained 'such dimensions as to affect the body politic of the Dominion.'[38] However, in 1976 the Supreme Court of Canada seriously undermined these aspects of the POGG power in its decision regarding the validity of the federal government's anti-inflation program.[39] Parliament's legislative initiative was upheld, it is true, and the POGG power seems to have been the main source of its constitutional validity. But the various judgements written by the members of the Court also seem to indicate that the anti-inflation legislation could not have been sustained because of any 'national dimensions' to the inflation problem. Rather, the legislation could only be upheld as an exercise of Parliament's emergency powers under POGG, which allow for federal intervention in otherwise provincial spheres of authority but only to deal with emergency situations on a temporary basis. For this reason, it is unlikely that POGG can now furnish much, if any, support for federal legislative initiatives aimed at regulating financial institutions generally and permanently.[40]

Three other potential sources of federal authority deserve mention here, although in each case there is not very much that can be said about them. First, Parliament has exclusive jurisdiction under section 91(21), 'Bankruptcy and Insolvency.' From this head of power flows the federal authority to regulate the affairs of insolvent financial institutions, even those that are provincially incorporated and whose business (insurance, for example) is otherwise within exclusive provincial jurisdiction.[41] But it is an open question, and one of considerable doubt, whether section 91(21) would permit federal intrusion into otherwise exclusive provincial areas for the purpose of preventing the insolvency of financial institutions generally on a prospective basis.[42]

Second, Parliament has exclusive jurisdiction under section 91(27), 'The Criminal Law,' and under this authority it may create offences and prescribe penalties in respect of fraudulent and similarly improper conduct in financial transactions.[43] But it is doubtful that the criminal-law power could be asserted to regulate the broad range of conduct in financial transactions that falls short of the usual standards of criminal culpability.[44] Moreover, the higher standard of proof required in criminal matters would likely reduce the effectiveness of criminal sanctions as regulatory tools.

Third, Parliament has exclusive jurisdiction, under sections 91(29) and 92(10), in relation to interprovincial 'Works and Undertakings' and any intraprovincial programs that Parliament has declared to be 'for the general Advantage of Canada.' Under section 91(29), there may be some federal authority to regulate interprovincial securities clearing and quotation systems that are dependent upon physical facilities (such as telephone lines) that cross provincial boundaries.[45] Similarly, it has been suggested that Parliament might resort to its declaratory power under section 92(10) to bring such intraprovincial works as stock exchanges within its exclusive jurisdiction.[46] The first suggestion may be of limited utility because a federal assumption of jurisdiction over any interprovincial 'Works and Undertakings' would not likely carry with it jurisdiction over the great bulk of financial transactions that depend only peripherally, if at all, on interprovincial communications networks and the like. The second suggestion may allow Parliament to reach a much broader range of intraprovincial works, along with their associated undertakings. But the unilateral exercise of the federal declaratory power entails such significant risks

of federal-provincial conflict that even the proponents of this suggestion appreciate that its use without provincial concurrence is unlikely.[47]

In the end, all that is really clear about the sources of federal authority in relation to financial institutions is that there are a number of heads of power under section 91 that could be asserted in aid of federal regulatory initiatives with respect to various aspects of various types of institutions. But in each case the scope – or potential scope – of federal jurisdiction is far from clear, and in that sense the boundary line between federal and provincial authority is also uncertain in many respects. Where Parliament has legislative authority, of course, then provincial jurisdiction under section 92 will either be ousted entirely (where Parliament's jurisdiction is exclusive of that of the provinces, as in the case of banking) or may still be exercised but subject to federal paramountcy (where both Parliament and the provinces may legislate concurrently regarding different aspects of the same subject matter, but the two measures conflict). As will be discussed further in the next section, Parliament has not often chosen to test the scope of its powers in relation to financial institutions. But Parliament must first find a secure source of legislative authority before it can act, and under our present constitutional arrangement that is not an easy task in most instances. At the root of the matter, of course, is the fact that there is nothing in section 91 (at least as the courts have construed it so far) that gives Parliament anything like the broad-based powers with respect to financial institutions that are available to the provinces under section 92(13). It should not, perhaps, be too surprising that in 1867 the Fathers of Confederation failed to articulate a clear theoretical basis for dividing federal and provincial powers in relation to financial institutions in the 1980s. Nor should it be surprising that a century of judicial development of the relationship between sections 91 and 92 may seem incongruous to modern eyes. But that is where we seem now to stand.

FEDERAL-PROVINCIAL REGULATORY FRAMEWORK

Introduction

This section will provide a short historical overview of the evolution of Canada's financial institutions and the regulatory framework governing them. The comparable history of the public law of financial

institutions in other Western societies – Western Europe and the United States – emphasizes the importance of geographical, political, and economic factors, and the absence of a single master plan to explain either the origins of particular institutions or the regulatory framework into which they have been cast.

This is no less true for Canada. Commercial banks are the oldest of our financial institutions, and their key role in the credit structure of the Canadian federation was quickly and explicitly recognized by the Fathers of Confederation and, as previously explained, subjected to the largely exclusive and overriding jurisdiction of the federal government. Although the powers of the banks have been expanded steadily in the successive bank acts, their subjection to this single level of control has remained a constant feature.

This has not been the case with the other principal types of financial institutions operating in Canada. Loan and trust companies had their beginnings in the preConfederation and early Confederation period and were initially the focus of provincial regulation. The federal government subsequently invoked its own incorporation and regulatory powers – why is not entirely clear. At any rate, it is now settled law that federal incorporation does not immunize such companies against provincial licensing and other regulatory requirements. However, there has been surprisingly little constitutional litigation on this point, and the precise scope and impact of the federal incorporation powers still remain to be judicially determined.

The allocation of powers in the insurance field proved to be much more litigious. Although the concurrency of the federal and provincial regulatory powers was early recognized, over a period of almost fifty years the federal government sought to establish its paramount jurisdiction. The attempts failed. Instead, since the early 1930s, the two levels of government, aided by a very willing industry and the Association of Superintendents of Insurance, have adopted a generally harmonious working relationship in which the federal government has assumed major responsibility for the public-law aspects of federally licensed insurance companies while the provinces have continued to apply their private-law rules and supervisory regimes to the actual contracts written by the insurance companies.

For reasons not easily explained, the federal government only recently has sought seriously to participate in the regulation of the Canadian securities industry. In the 1960s, the federal government

indicated interest in exploring the desirability of a federal securities law by sponsoring the monumental intellectual effort, *Proposals for a Securities Market Law for Canada*.[48] However, nothing materialized. An earlier Ontario-sponsored proposal for a Canadian Securities Commission (Cansec) to facilitate the uniform administration of provincial securities laws evoked little support from either the federal or other provincial governments.

In terms of their history, credit unions and caisses populaires are the youngest members of the fraternity of financial institutions. However, they have grown rapidly since the Second World War and now constitute a major financial force in Quebec and the Western provinces. Constitutionally, because of their member-oriented character and their strong local roots, credit unions and caisses populaires have always been regarded, and continue to be regarded, as quintessentially subject to provincial control and supervision. Indeed, for a long time, the federal government resisted pressure from the credit union movement for the incorporation of an interprovincial central agency and stabilization fund, and only relented with the adoption of the federal Co-operative Credit Associations Act in 1953.

This historical overview does not attempt to deal with the development of some significant financial intermediaries of late, notably mutual funds and pension funds, the importance of which should not be discounted.

The Royal Commission on Banking and Finance[49] was struck by the diversity of laws governing Canada's financial institutions and the artificial character of the division between the federal and provincial legislative powers. Its report urged that federal regulation be made compulsory for all private institutions doing a banking business, and that other institutions be prohibited 'unequivocally' from operating as banks – that is, accepting funds from the public in demand form or short term accounts.[50] However, these pleas were not heeded. The federal government decided to proceed with the implementation of a statutory insurance scheme for depositors, the Canada Deposit Insurance Corporation Act having been enacted in 1967. Although the Canada Deposit Insurance Corporation (CDIC) was perceived at the time as only a relatively minor element in the overall regulatory structure, and not as an important unifying element, subsequent events have given it a much higher profile in both respects.

Perhaps this proves again the persuasiveness of Justice Holmes' famous aphorism that 'the life of the law is not logic but experience.'

Development of regulatory framework

Banks

Banks emerged in Canada during the early nineteenth century as the first significant financial intermediary in the Canadian economy, largely because of the shortage in Canada of media of exchange.[51] The first Canadian bank was the Montreal Bank, formed in 1817 as a limited liability company under private articles of association. Chartered banks began to appear in the early 1820s and soon dominated the commercial banking field in Canada.[52] By royal charter and by legislation of the Province of Canada, numerous note-issuing commercial and savings banks were established prior to Confederation.[53]

The Dominion of Canada passed its first general banking statute, The Dominion Banking Act,[54] in 1871. All existing banks were required to obtain charters and, *inter alia*, to meet certain capital requirements. The Act became the corporate charter of all banks governed by it.[55]

The enactment of a general banking statute soon after Confederation was probably the result of a desire for uniformity in the banking industry and the federal government's wish to assume control over the federal system.[56] Banks were authorized to engage in 'such trade generally as appertains to the business of banking.' The Act listed a series of specific powers that were given to banks and that probably constituted the essence of banking in 1871. For example, banks could issue notes, deal in the discounting of promissory notes and negotiable securities, buy and sell gold and silver bullion, acquire and hold warehouse receipts, accept deposits, and make loans. Banks were prohibited from lending on the security of real estate, ships and other vessels, goods, wares, and merchandise, from buying and selling goods, wares, and merchandise, and from engaging in any business other than banking.. The restrictions were steadily relaxed, and, in particular, the celebrated section 88 provision[57] enabled the banks to take a simple form of security in inventory, raw materials, and natural resources held by manufacturers and wholesalers, farmers and fishermen, as well as members of the forestry and extractive industries.

In 1900, the Canadian Bankers' Association, a voluntary organization of banks to promote their common interests, was given official recognition by Parliament.[58]

The number of chartered banks in Canada remained fairly constant until about the time of the First World War, when failures, amalgamations, and mergers resulted in a reduction in their number.[59] It has been suggested that concentration in the banking industry was the result of at least two factors: (1) barriers to entry such as increased minimum paid-up capital requirements and a shortened period after the granting of a charter in which to raise required capital and obtain a permit to begin operation; and (2) the lack of legislation prohibiting amalgamations and mergers.[60]

Since 1871, the Bank Act has undergone regular periodic review and amendment, often called the 'decennial revision' of the Act.

As early as 1870, discussion arose concerning the introduction of cash reserve requirements for banks.[61] In 1890, the Bank Act[62] established the Bank Circulation Redemption Fund requiring banks to make contributions to the fund for the purpose of redeeming the notes of failed banks.[63] A cash reserve ratio was first introduced in 1934, requiring banks to hold a certain percentage of their deposits with the Bank of Canada, which was formed the same year.[64] The original purpose of the cash reserve ratio was to ensure that banks would always be in a position to redeem on demand their note and deposit liabilities. But the Bank of Canada began to manage cash in the monetary system and act as lender of last resort to the banks, thereby lessening somewhat the importance of the cash reserve ratio.[65]

The power of Canadian banks to lend money against new forms of security was extended by Parliament as the need arose. In 1936, the Canadian Bank of Commerce first engaged in the personal instalment loan business.[66] In 1954, banks began to make government-guaranteed residential mortgage loans under the National Housing Act[67] and consumer loans against the security of chattel mortgages.[68] These developments put banks in direct competition with a variety of trust, loan, insurance, and co-operative companies. With the major revision of the Bank Act in 1967,[69] banks were allowed to make conventional unguaranteed mortgage loans and to take security generally in personal property.

Even before Confederation, banks were faced with a ceiling on the level of interest rates they could charge. The ceiling rate was 7 per

cent until 1944, when it was lowered to 6 per cent.[70] The interest rate ceiling was removed in 1967.[71]

The 1967 Bank Act revisions also introduced restrictions on bank equity holdings on the recommendation of the Porter Commission.[72] The legislation[73] restricted bank equity ownership in Canadian corporations (other than ownership in trust or loan corporations) to 10 per cent of all voting shares of the corporation where the total amount paid for all shares owned by the bank was in excess of $5 million, and 50 per cent of all voting shares of the corporation in other cases. Bank equity ownership of trust or loan corporations was limited to 10 per cent of all voting shares. The law prevented banks from circumventing these rules through control of foreign corporations.[74]

Also in 1967, Parliament enacted the Canada Deposit Insurance Corporation Act,[75] which requires all federally incorporated deposit-taking institutions (i.e., banks, trust and loan companies) to qualify for deposit insurance with the CDIC. The statute also allows provincially incorporated deposit-taking institutions (i.e., trust and loan companies) to apply to the CDIC for deposit insurance if authorized to do so by their province of incorporation, and if they agree to conform with the regulatory provisions of federal legislation.[76] Provincially incorporated trust companies and loan companies that enter into a contract of insurance with the CDIC become, like their federal counterparts, subject to examination by the federal Superintendent of Insurance.[77]

Neufeld summarizes the evolution of banking regulation up to 1972 as follows:

> It seems that the banks did not, over the years, labour under harmfully restrictive legislation with respect to their borrowing and lending activities. Changes and lending regulations came soon after they were desired while provisions relating to bank liabilities did not restrict the banks' operations – with the exception of the requirement that the banks until 1913 had to pay off their notes in specie on demand, had to maintain a minimum cash reserve ratio after 1934, and were gradually deprived of the note issue after that year . . .
>
> What then may we conclude about the impact of legislative restrictions on the banks? First, not until at least 1955 did the legal interest rate ceiling or legal cash ratio requirements

place the banks at a competitive disadvantage. Second, the banks obtained new lending powers almost as soon as they wanted them, because of the decennial revision of the Bank Act; and not until 1962 did they themselves publicly argue in favour of being permitted to make conventional mortgage loans. Third, the banks have enjoyed almost complete legislative freedom in the type of liability instruments they can issue. So the greater part at least of the relative decline in the size of the chartered banks cannot be explained by restrictive legislation.[78]

The current Bank Act is Part I of The Banks and Banking Law Revision Act, 1980.[79] These changes were introduced to ensure that banking services are offered widely and at competitive rates:

1 For the first time, the entry of foreign bank subsidiaries was permitted.

2 Banks may now engage in commercial leasing and factoring through subsidiary corporations.[80]

3 Banks may also form subsidiary joint venture corporations and export finance companies to provide financing and loans, involving both debt and equity participation, to Canadian corporations.[81]

4 Banks were given the express authority to offer for sale, sell, and provide retirement savings plans, home ownership savings plans, and retirement income funds.[82]

5 The Income Tax Act (Canada) was amended so that deposits with members of the Canadian Payments Association (CPA) qualify for use in such plans and funds, thereby allowing banks to administer them without resort to the services of a trust company.[83]

6 Banks were prohibited from underwriting corporate securities, but were allowed to act as part of a selling group.[84] Prior to 1980, there were no federal restrictions on underwriting, brokerage, and distribution of corporate securities by banks, but banks did not actively exercise this power.[85]

The 1980 revisions also established the CPA to operate a national cheque-clearing system, not only between banks, but between banks and other deposit-taking financial institutions.[86]

Since 1980, the banks have further eroded the traditional four pillar concept in the Canadian financial system. With its discount brokerage access service (the Greenline Investor Service), the Toronto-Dominion Bank has taken advantage of price deregulation in the securities industry and of section 190(4)(b) of the present Bank Act, which allows a bank to act as agent of a vendor or purchaser of equity securities if the transaction is effected by a broker. Prior to so doing, the Toronto-Dominion Bank voluntarily participated in a public hearing convened by the Ontario Securities Commission and agreed to register with that agency.[87] In contrast, the National Bank of Canada has challenged the jurisdiction of the Quebec Securities Commission to require it to register as a broker for the purpose of administering the Quebec stock savings plan and the indexed security investment and self-directed registered retirement savings plans under the Income Tax Act (Canada).[88]

Trust companies and loan companies

Historically, traditional trustee functions were performed by lawyers, accountants, and other financial agents. Trust companies, however, began to emerge in Canada soon after Confederation.[89] Early trust companies in Canada were incorporated mainly at the provincial level to perform traditional trustee functions. Fewer trust companies were incorporated at the federal level, partly because of the provincial legislative authority over trustee activities and partly because, until 1970, federally incorporated trust companies required a special act of Parliament for their incorporation.[90] Federal incorporation, however, has since proved popular.

A distinctive contribution of trust companies to the financial system in Canada, and to the maintenance of the four pillar doctrine, has been their exclusive right among financial institutions to provide a variety of executor, administrator, and other trustee services. Even now, banks, loan companies, life insurance companies, and credit union co-operatives are not permitted to engage in discretionary fiduciary activities.[91]

Loan companies raise funds from the public mainly for the purpose of mortgage lending and investment. Legislation governing loan companies is very similar to that governing trust companies except, of course, in the area of trust business because loan companies operate

without trustee powers. We shall, therefore, focus on the development of legislation governing trust companies.

In 1872, the Ontario legislature passed a bill incorporating the Toronto General Trust Company and extending trust company powers to an existing loan company.[92] The number of trust companies created by the provinces expanded rapidly thereafter. Early legislation granted comprehensive trustee powers, attempted to ensure solvency, and specifically prohibited trust companies from engaging in the business of banks, loan companies, or life insurance companies.[93]

General legislation governing trust companies was passed in Ontario in 1897.[94] Other provinces followed with similar legislation. Previously, legislation had dealt only with the chartering of trust companies.[95] The attempt to prevent them from engaging in banking consisted of provincial (and later federal) legislation prohibiting trust companies from issuing debentures and receiving deposits other than in trust.[96] These restrictions were without real economic significance because trust companies were not prohibited from taking in trust short-term deposits with guaranteed repayment and interest and longer-term deposits by issuing guaranteed investment instruments other than debentures.[97] Trust company deposits and guaranteed trust certificates are, practically speaking, indistinguishable from bank deposits and loan company debentures from the point of view of potential depositors.

In 1914, Parliament enacted general legislation governing federally incorporated trust companies.[98] Prior to 1914, several trust companies had been incorporated by special act of Parliament under federal companies legislation. The objectives of the federal Trust Companies Act of 1914 were basically the same as those of the earlier provincial acts.

In the recent Canadian Pioneer Management Ltd[99] decision, the majority of the Supreme Court of Canada adopted an institutional approach in determining whether a trust company was engaged in the business of banking. Acknowledging that the approach emphasizes formal tests, Justice Beetz noted:

> The characterization of legislation and the characterization of a business are not identical processes. Legislation for instance, may be divisible whereas a business as a going concern

> is indivisible and must stand or fall as a whole on one side of the constitutional line or the other.[100]

The late Chief Justice Laskin, in a concurring opinion, lamented the 'outworn conceptions of the business of banking . . . untouched by federalism and by the rise of new types of credit institutions which exercise powers similar to those long exercised by banks.'[101] He observed:

> Even if Parliament could have brought trust companies within its regulatory authority in relation to banking, it has chosen not to do so, and I think that this Court should respect that position.[102]

Early legislation attempted to guarantee the security of funds deposited in trust with companies by fixing a ratio between guaranteed liabilities and funds that trust companies were required to maintain. For example, the initial federal statute restricted the sum of a trust company's borrowing and funds under guarantee to five times the trust company's paid-up capital and reserve.[103] This ratio was expanded substantially over the years, and the present limit on the amount of money that a federal trust company may take as trust moneys (guaranteed or borrowed) is 12.5 times the excess of the trust company's assets over its liabilities and may be increased with the approval of the federal minister of finance to twenty times and even higher where additional financial requirements are satisfied.[104] Substantially similar provisions exist in the Ontario act in respect of trust companies incorporated in Ontario.[105] The statutes do not give the regulatory authorities express authority to reduce this ratio if the financial condition of a particular trust company warrants a reduction.

Limitations on the type of investments that trust companies may make are intended to ensure their solvency. Basically, trust companies may invest in mortgages, government securities, real estate, secured corporate debt, and, if certain quality tests are met by the issuing corporation, unsecured corporate debt and equity. Trust companies may also invest a portion of their funds at their discretion through so-called basket provisions in the various trust companies acts.

Small, provincially incorporated trust companies that carry on business only in their province of incorporation have, partly due to an

active merger movement in the industry, been substantially replaced by larger provincially and federally incorporated trust companies that carry on business across the nation.[106] Many provincially incorporated trust companies have chosen since 1970 to be continued under federal legislation[107] and thereby become subject to federal regulation. Also, some provinces have by legislation or agreement granted authority to examine trust companies incorporated within their borders to the federal Department of Insurance.[108]

As discussed above, the Canada Deposit Insurance Corporation Act of 1967 requires federally incorporated trust and loan companies to be insured under the Act and allows provincially incorporated trust and loan companies to qualify for deposit insurance with the CDIC. Ontario established its own deposit insurance scheme in 1967, but amended it in the same year to require Ontario trust and loan companies to apply for deposit insurance with the CDIC.[109] Quebec has its own deposit insurance scheme applicable to provincially incorporated institutions accepting deposits in Quebec.[110] Quebec and the federal government have agreed that deposits received by Quebec companies from outside the province will be insured by the CDIC.

Life insurance companies

Life insurance has traditionally been the payment of a specific sum upon the happening of a future event. Historically, secure investments have included mortgages and government bonds to ensure the availability of funds to meet such predetermined long-term obligations.[111]

Life insurance was introduced into Canada by British insurance companies. There was no active Canadian insurance company until the formation of the Canada Life Assurance Company in 1847, which was allowed under its charter to accept deposits and which invested its funds mainly in bank stocks, provincial debentures, and outstanding mortgages.[112]

The constitution does not specifically grant legislative authority over insurance to either level of government. Because of its financial importance, the insurance industry in Canada attracted legislative controls early in its history. For over half a century, the federal government attempted to assert primary jurisdiction over the conduct of the insurance business in Canada, but was rebuffed by the courts on every occasion. As a result, it is now well settled that the provinces

have the power to regulate insurance activities within their borders regardless of the law of incorporation of the particular company. Since then, the federal and provincial governments have adopted a de facto working relationship that generally avoids excessive duplication of regulatory controls over the insurance industry.[113]

In 1881, the Privy Council upheld the validity of an Ontario statute that required that certain provisions be contained in all fire insurance policies entered into in Ontario on the basis that the matter came under section 92(13) as opposed to the federal power over trade and commerce in section 91(2).[114] In 1916, the Privy Council found the Federal Insurance Act of 1910 to be unconstitutional in that it attempted to prohibit the business of insurance (except by provincially incorporated insurance companies that operated only in their province of incorporation) unless the company had been licensed by the federal minister of finance. It was held that the regulation of a particular industry comes within 'Property and Civil Rights in the Province' even where the industry and particular firms within the industry extend beyond provincial boundaries.[115]

In 1924, a provision in the Criminal Code requiring anyone carrying on the business of insurance to obtain a licence was struck down as a colourable attempt to interfere with property and civil rights in the province.[116] And in 1932, federal legislation that attempted to require nonresident British subjects and aliens to obtain a licence before carrying on the business of insurance and to impose a tax on persons taking out insurance with such foreigners was also struck down. Federal legislative authority over immigration, aliens, and taxation, it was held, did not support the legislation.[117]

The first general legislation governing life insurance companies was the federal Insurance Companies Act of 1868,[118] which was taken largely from earlier non-life-insurance legislation of the Province of Canada. Federally incorporated and foreign insurance companies were required to be licensed with the minister of finance and to deposit a portion of their assets in trust in order to meet existing liabilities. The Act was clearly aimed at controlling the legal status of existing and future insurance companies and ensuring their solvency, since most were controlled from outside Canada. Provincially incorporated insurance companies were excluded from the legislation.[119]

Public pressure and government concern over failures of English and American insurance companies resulted in the enactment of

further federal legislation in 1875 and 1877,[120] laying a foundation for the supervision of the insurance industry in Canada. Publication of information about the affairs of insurance companies for the benefit of the insuring public and ensuring the solvency of insurance companies were the main objects of the legislation.[121] All federally incorporated and foreign insurance companies were required to maintain assets in Canada sufficient to cover liabilities and to show actuarial reserve liabilities on their financial statements at least equal to the claims of policy holders. The office of Superintendent of Insurance was created and authorized to conduct annual examinations of all insurance companies. Insurance companies were required to make annual statements available to the public. An interest rate of 5 per cent and mortality tables were prescribed for use in computing liabilities to policy holders.

After the 1870s, federal legislation focused mainly on controlling the investments that insurance companies were permitted to make.[122] The federal Insurance Act of 1910 imposed quality standards on the type of investments that could be made by federally regulated companies.[123] These provisions have survived in much the same form to the present day, as have similar provisions in the trust companies and loan companies acts.[124]

The enactment by the federal government in 1932 of the Canadian and British Insurance Companies Act[125] and the Foreign Insurance Companies Act[126] was an attempt by the federal government to establish its constitutional competence over insurance companies and the business of insurance.[127] The preambles to those statutes recognized that earlier federal legislation had been struck down as *ultra vires* (in that it dealt with regulation of the business of insurance within a province) and attempted to establish constitutional bases for them.

The Canadian and British Insurance Companies Act relied for its constitutionality on federal legislative authority over the status and powers of federally incorporated companies, registration of British insurance companies doing business in Canada, interprovincial and international trade, and the prevention of insolvency in the insurance industry.[128] The Foreign Insurance Companies Act of 1932 relied for its constitutionality on federal legislative authority over international trade and commercial relations of Canada, registration of foreign companies doing business in Canada, insolvency, and aliens.[129]

Whether these sources are sufficient to justify these statutes in their entirety is unclear. There has not been a constitutional challenge to federal legislation concerning insurance since 1942.[130] Federal control of the insurance industry has depended largely upon the continued co-operation of the provinces and the industry rather than a solid constitutional basis.[131] However, there is little doubt about the competence of the provinces to regulate all aspects of insurance business conducted within their borders by federally incorporated insurance companies.

Early provincial legislation[132] governed provincially incorporated insurance companies and the business of insurance in the province. Although provinces had the power to incorporate local life insurance companies, the business of such companies has never exceeded about 10 per cent of the business of federally registered life insurance companies.[133] Provincial legislation now provides for the complete corporate chartering of insurance companies through provincial insurance and corporations statutes. Provincially incorporated insurance companies may register at the federal level under the Canadian and British Insurance Companies Act and thereby carry on business across Canada.

As a condition of such registration, provincially incorporated insurance companies must undertake to comply with all applicable provisions of that Act.[134] Provincially incorporated insurance companies can thereby avoid the substantive requirements of the legislation of each province and limit their dealings to the federal Superintendent of Insurance. In a practical sense, federal inspection exempts provincially incorporated companies from the requirements of other provinces because of the substantial similarity of federal and provincial legislation.[135] Federal registration or incorporation does not avoid compliance with individual provincial requirements concerning the writing of insurance contracts. However, as a result of the efforts of the insurance industry acting in conjunction with the Association of Superintendents of Insurance, provincial insurance acts have exhibited a large measure of uniformity on these points until recently.

Today, the federal government is largely responsible for registering and supervising all federal, British, and foreign insurance companies.[136] The thrust of the legislation is toward ensuring solvency through provisions dealing with the quality of investments and

establishing annual examinations of individual companies by the Superintendent of Insurance. Provincial governments are similarly responsible for provincially incorporated insurance companies, and have directed their attention principally toward the contents of insurance policies and the licensing of agents, brokers, and adjusters.[137]

The expanded role of the chartered banks as a financial intermediary and the development of pension and mutual funds have challenged the traditional role of life insurance companies in providing a medium for safe, long-term investment of savings. Life insurance companies have expanded their investment objectives into equity investments that can provide a greater return. Although life insurance companies have the exclusive right to sell life insurance, they have expanded into selling variable value policies and contracts of annuity (i.e., close substitutes for term deposits) and have become financial institutions geared toward long-term investments.[138] Several life insurance companies have recently acquired significant interests in trust companies.[139]

Quebec has recently amended its insurance legislation to broaden the powers of insurance companies and enable them to engage in non-insurance-related financial activities.[140] Insurance companies incorporated in Quebec may now provide for the financing of insurance premiums and annuity contributions, offer for sale the services of other financial institutions, engage in leasing operations, manage immovables, and carry on any other activity authorized by the Quebec minister of finance.[141] Where the noninsurance activities of an insurance company constitute more than 2 per cent of its gross revenues, the minister may require the establishment of a subsidiary to carry on such activities.[142] The legislation also abolishes the traditional qualitative investment standards, as they apply to insurance companies incorporated in Quebec, in favour of a 'prudent and reasonable person' standard.[143]

Securities dealers

The core function of a securities dealer is the underwriting of corporate securities, both as principal and agent, to raise permanent and long-term capital. Dealers distribute securities to the public and thereby facilitate the trading of securities through stock brokerage and counselling activities.[144]

Legislative authority over the trading of corporate securities within a province lies with the provinces as an aspect of their power to regulate 'Property and Civil Rights in the Province.' Provincial regulation of the securities industry may pose constitutional problems where federally incorporated companies are involved, because provincial legislation must not 'impair' or 'sterilize' the essential attributes or corporate status of a federally incorporated company.[145]

Constitutional problems also arise where provinces attempt to regulate corporate law aspects of federally incorporated companies and where provincial securities legislation conflicts with federal company legislation.[146] Provincial securities legislation may validly protect the public against fraudulent, false, or misleading information contained in prospectuses, but it may also limit the freedom with which federally incorporated companies may otherwise raise capital. Provincial legislation with a double aspect such as this may be invalid where it seriously conflicts with federal company legislation. For example, the insider-trading and proxy-solicitation provisions of provincial securities legislation may invade the federal jurisdiction by affecting the relation between the directors and shareholders of a federally incorporated company and by seeking to regulate the solicitation of proxy votes at shareholder meetings. The provinces may have sidestepped a potential constitutional conflict by allowing exemptions from insider-trading and proxy-solicitation requirements where a company is subject to similar requirements under the law of its jurisdiction of incorporation.[147]

In the absence of federal securities legislation, courts have generally been reluctant to strike down provincial securities legislation and thereby create a regulatory gap.[148] Securities regulation directed at activities carried out within the province is *intra vires* the provinces, but this does not mean that the provinces have no legislative competence over interprovincial and international securities transactions.[149] The Supreme Court of Canada has upheld the application of the Quebec Securities Act to securities dealers in Quebec who conduct all their business with clients residing outside Canada.[150] Likewise, the Manitoba Court of Appeal has upheld the application of the registration provisions of Manitoba securities legislation to securities dealers in Ontario who correspond with Manitoba residents.[151]

Modern securities regulation began with provisions in various English companies acts in the mid-nineteenth century.[152] Until 1912,

securities legislation in Canada was confined basically to disclosure requirements relating to new issues and paralleled closely early developments in the English companies acts. The basic disclosure requirements in England were adopted in the federal and provincial companies acts in Canada.[153] Ontario adopted a Directors' Liability Act[154] in 1891 and introduced prospectus-content provisions into its Companies Act in 1907.[155] The Ontario Companies Act[156] of 1912 adopted the 'private company' and 'statement in lieu of prospectus' concepts and applied them equally to underwritten and direct offerings by an issuer.[157]

'Blue sky' legislation was introduced into Canada in 1912 by Manitoba's Sale of Shares Act[158] and was directed at controlling issuers of securities rather than at the disclosure of information. The use by insiders of information unavailable to the public had made trading on stock exchanges unfair and a matter of public concern.[159] The Manitoba legislation was basically a copy of the original 'blue sky' legislation enacted by the state of Kansas.[160] The Sale of Shares Act gave the Manitoba government general supervision and control over the activities of issuers[161] by requiring them to obtain permits before offering securities and by requiring the registration of securities, salesmen, and agents of the issuer. Issuers were required to maintain business records and file financial information and periodic reports.[162] Other provinces soon followed with 'blue sky' legislation of their own.[163]

Fraudulent stock promotion led to the enactment of fraud prevention legislation between the wars.[164] Ontario passed the first Security Frauds Prevention Act[165] in 1928, which combined fraud prevention provisions with the requirement that brokers and salesmen be registered. The Act listed various activities that were prohibited. Requirements for disclosure relating to new issues were moved to the Companies Information Act.[166] A uniform act was passed in 1930 by all provinces except New Brunswick. Provincial acts were later substantially amended, and that level of uniformity has yet to be effectively regained.[167]

While provincial securities legislation developed, federal legislation continued to emphasize disclosure requirements in the Companies Act. In 1917, the concepts of 'private company' and 'statement in lieu of prospectus' were adopted, disclosure of financial statements was required, and prospectus content provisions were introduced.[168]

In 1934, federal attention turned to sales practices, but the Companies Act did not apply to the issuance of shares through an underwriter on a firm commitment basis.[169] The federal government was of the view that Parliament had no constitutional authority to regulate the sale of securities by their owner.[170] In 1935, however, Parliament made the prospectus provisions of the Companies Act applicable to federally incorporated companies issuing securities to be sold by an underwriter. Parliament also prohibited directors of a federally incorporated company from speculating in securities of the company and required disclosure of all trades by directors in such securities.[171]

The Ontario Securities Commission[172] (OSC) was created in 1933 and began operations in 1937. Ontario enacted a substantially revised Securities Act[173] in 1945, again prompted partly by continued fraudulent activity in the sale and promotion of speculative mining issues, which drew criticism not only from Ontario but also from the United States.[174] The OSC was authorized to investigate alleged violations of the Securities Act and to audit the affairs of brokers, who were required to file annual financial statements with the commission. The OSC was also empowered to freeze the funds or securities of any person being investigated. Stock exchanges were prohibited from carrying on business without its consent. Various provisions regulating trading practices and increasing disclosure requirements were also introduced.

The Toronto Stock Exchange (TSE) was formed in the mid-1800s to establish a market for industrial (and initially bank) equity securities in Upper Canada.[175] Through mergers with various mining exchanges,[176] the TSE became the only stock exchange operating in Ontario recognized by – and subject to the oversight of – the OSC. The Montreal Exchange was incorporated in 1874, and other exchanges were later incorporated throughout Canada.[177] Today, five stock exchanges (Toronto, Montreal, Winnipeg, Alberta, and Vancouver) and the Toronto Futures Exchange are recognized under provincial legislation. While largely self-regulating, each is subject to the provincial securities administrator. The Winnipeg Grain Exchange is an unincorporated and voluntary association of members organized to operate a grain-and-produce exchange in Winnipeg and is subject to federal supervision by the Canadian Grain Commission.[178]

The rapid growth of the Canadian economy in the post-1945 era, the existence of comprehensive securities legislation in the United States,

and the continued abuse of inside information resulted in the appointment of the Attorney General's Committee on Securities Legislation in Ontario (the Kimber Committee) in 1963 to investigate and report on the operation of securities legislation in the province.[179] The report of the Kimber Committee resulted in a major overhaul of the Securities Act in 1966.[180] The new Act introduced provisions dealing with proxy solicitations, take-over bids, continuous disclosure of financial information by issuers, and reporting of and liability for insider trading.

Yet another Securities Act was introduced in Ontario in 1978.[181] The Act introduced the 'closed system' and the concept of a 'reporting issuer' in an effort to provide continuous disclosure in secondary markets for publicly distributed securities. The focus of the disclosure requirements of the Act shifted from the registration of particular securities to the registration of issuers. Provisions dealing with take-over bids were strengthened, and a framework for the regulation of issuer bids was developed. Various new civil liability provisions were also introduced.

In 1979, the federal government released the Report of the Federal Task Force on Proposals for a Securities Market Law for Canada. The Porter Commission had recommended in 1964 that the Canadian securities market be federally regulated.[182] In 1975, the Canada Business Corporations Act[183] came into force, introducing insider-trading, proxy-solicitation, and take-over bid requirements for federally incorporated business corporations. The task force presented a draft federal securities act which recognized the national scope of financial markets in Canada and envisaged a federally co-ordinated system of regulation setting national standards to be administered with the co-operation of provincial securities regulators.[184]

Credit unions and caisses populaires

Credit unions and caisses populaires, often called co-operative credit societies, are financial institutions organized under provincial legislation that are owned by their members and stress the principles of co-operation as applied to borrowing and lending.

The co-operative movement began in Europe in the mid-1800s as a means of encouraging thrift among the poor and providing them with satisfactory borrowing facilities. Commercial institutions of the time did not cater to individuals of limited means. The co-operative move-

ment demonstrated the productive use that could be made of the savings of low-income people acting as a community.[185] Co-operative credit societies were conservative in their loan practices, lending money only to members and only for purposes considered to be economically productive.[186]

At the same time, a credit union movement emerged in the United States. Similarity of employment or social characteristics was adopted as the common bond that formed the basis for membership.[187] Credit unions that soon emerged in English-speaking Ontario and elsewhere in Canada followed the American example of the common bond based on employment and social characteristics.[188]

The first legislation in Canada governing co-operative credit societies was Quebec's Co-operative Syndicates Act[189] of 1906. It applied not only to caisses populaires but also to agricultural syndicates. Co-operative syndicates incorporated or continued under the Act were joint-stock companies with a three-tier system of management (i.e., board of management, board of supervision, and committee of credit) selected from, and reporting to, the general meeting of members. Co-operative syndicates were only permitted to make loans to members, who were required as a precondition to membership to buy shares. Emphasis was placed on mortgage lending for houses.[190]

Ontario was the next province to introduce legislation governing co-operative credit societies. Its Co-operative Credit Societies Act[191] was adopted in 1922, but not proclaimed until 1937. According to the Act, the objects of co-operative credit societies were 'the receiving of monies on deposit from members and the making of loans to members with or without security.'[192] The Act provided that:

1 Each member of a society was a shareholder and was entitled to one vote regardless of the size of his shareholdings.

2 Societies were required to set aside a minimum of 10 per cent of annual net profits and to credit it to a guarantee fund designed to meet any losses.

3 Societies were prohibited from advancing money to or accepting deposits from persons other than members.

4 The affairs of societies were subject to inspection by the responsible minister upon the application of one-tenth of the total membership.

This law was re-enacted in 1940 as the Credit Unions and Caisses Populaires Act[193] and was superseded in 1976 by a new act.[194]

According to Ontario's present Act, the objects of a credit union are 'the promotion of co-operative enterprise, the facilitating of the accumulation of savings and the creation of a source of credit for its members at conscionable rates of interest and the provision of full financial services for its members.'[195] Provisions dealing with the investments that credit unions may make are similar to those for trust, loan, and insurance companies. The Ontario Share and Deposit Insurance Corporation[196] was created in 1976 to insure the deposit of all credit unions incorporated in Ontario up to a specified amount.[197] Ten or more credit unions may incorporate a league of credit unions under the Act, which may enter into agreements with the CDIC and with other leagues, including members of federally registered associations.[198]

In the 1920s, regional unions began to emerge in Quebec to provide financial services such as emergency loans and cheque-clearing facilities to local caisses populaires. The evolution of a system of 'centrals' soon followed in the credit union movement elsewhere in Canada. In 1932, regional unions in Quebec formed the Fédération de Québec des Caisses Populaires Desjardins for their common supervision, with financial assistance from the Quebec government.[199]

Credit unions and caisses populaires raise funds from both the issuance of shares and the acceptance of deposits. The caisses raise most of their funds by accepting deposits, as large shareholdings are discouraged in order to prevent large withdrawals. Credit unions, in contrast, receive most of their funds by issuing shares.[200]

During the 1930s, Nova Scotia and St. Francis Xavier University became active in the formation of credit unions throughout English-speaking Canada. Nova Scotia passed general legislation respecting credit unions in 1932, and Prince Edward Island, New Brunswick, Manitoba, Saskatchewan, Alberta, and British Columbia followed shortly thereafter with legislation of their own.[201]

Parliament adopted the Co-operative Credit Associations Act[202] in 1953 to facilitate credit union pooling on the national level.[203] The Act provides for the voluntary registration of provincial centrals as associations under federal legislation and the establishment of the Canadian Co-operative Credit Society Limited (CCCS). The CCCS acts as a central bank for provincial centrals and is supervised by the

federal Superintendent of Insurance.[204] Under the present Act, the CDIC is authorized to make short-term loans to associations to enable them to maintain their liquidity and may request the federal Superintendent to examine associations affairs.[205] The CDIC may also provide deposit insurance for members of credit unions.[206]

Another provision of federal legislation is that centrals and federations of local co-operative credit societies that accept deposits transferable by order to a third party are entitled to become members of the CPA if they are members of the CCCS or meet other financial stability requirements prescribed by statute.[207]

The only regional union in Quebec to join the CCCS has been the Quebec Credit Union League. The numerous other federations in Quebec operate solely under Quebec legislation.[208] Six provincial centrals outside Quebec have joined the CCCS and are thereby subject to federal regulation.[209]

The constitutional jurisdiction to regulate credit unions and caisses populaires lies with the provinces, at least insofar as local societies are concerned. Inspection and supervision of local societies are currently the responsibility of the provincial governments and of the provincial leagues and federations of credit unions and caisses populaires.

For many years, Parliament declined to legislate in respect of credit unions and left the field to the provinces. Several attempts by the co-operative movement in the early twentieth century failed to have Parliament enact general legislation governing co-operative credit societies. The prevailing federal view at the time was that such legislation would be outside federal jurisdiction.[210] Since 1953, with the enactment of the Co-operative Credit Associations Act, Parliament has begun to exercise its potential constitutional jurisdiction over the provincial centrals to which local societies belong.

The constitutionality of provincial legislation governing credit unions was challenged in *La Caisse Populaire Notre Dame Limitée* v. *Moyen*.[211] The Saskatchewan Queen's Bench trial judge said:

> I am satisfied that although the Credit Union Act sets up corporations which may engage in 'banking', its pith and substance is to provide for a means whereby its members may be encouraged to save and use savings to assist each other and the powers given to it to engage in activities which banks are authorized to engage in are only ancillary to the carrying out of such a purpose, and so not an intrusion into the federal field

of s. 91(15) and therefore [the legislation] is *intra vires* the Province under s. 92(11) and (13).[212]

Summary of formal regulatory position

In a formal sense, the current regulatory picture of Canadian financial institutions could look scarcely less harmonious or more diverse and complex. Only the commercial banks can claim the good fortune (with marginal exceptions) to be regulated by a single level of government and a substantially integrated statutory regime.[213] All the other financial intermediaries are exposed to multiple levels of government control.

To be more specific, a trust or mortgage loan company may be incorporated under provincial or federal law. It is subject to the law of its incorporation and, if it is a federal company, also to the law of every province in which it carries on business. If it is provincially incorporated and operates extraprovincially, it will require permission to do so from the host province and it must meet its other regulatory requirements. These may not be the same as those of the law of incorporation. The trust or loan company may also be subject to non-uniform foreign ownership restrictions. Life insurance companies operate under substantially the same diversity of regulatory regimes as trust and loan companies, with the exception that up to now they have not been subject provincially to foreign ownership limitations.[214]

The picture is somewhat different with respect to the securities industry. Each province has its own securities act and regulatory authority (in the form of a securities commission or other body or single official). The federal government has no securities act but regulates important aspects of the market affecting conduct of federally incorporated corporations (i.e., with respect to insider trading, proxy solicitations, and take-over bids) through the Canadian Business Corporations Act. One consequence of the multiplicity of provincial securities regimes is that public offerings of a new issue must be cleared in each jurisdiction in which the issue is offered for sale; likewise, securities dealers must be separately licensed in each province in which they conduct their business and submit to its supervisory regime of rules and practices.

Jurisdictionally, credit unions and caisses populaires fare rather better than the other non-bank financial institutions. Typically, credit union and caisses populaires branches do not operate outside a

geographical locality or, in the case of vocationally related credit union branches, outside the employer's place of business. As a result, multiple jurisdictional problems do not normally arise. Further, federal government involvement in the incorporation and regulation of co-operative credit societies has so far been on a very limited scale.

The operational picture

Fortunately, the operational picture confronting financial institutions is not as bleak as an abstract consideration of the constitutional and legislative factors may suggest. This is so for a variety of reasons. First, federally incorporated banks account for about 50 per cent of the assets of all Canadian financial institutions.[215] Second, federally incorporated mortgage loan and trust companies account for 66 per cent of the total assets of Canadian loan and trust companies. The ratio for federally regulated life and health insurance companies is still more impressive – a preponderant 91 per cent – while the corresponding figure for property and casualty insurance companies is a hefty 71 per cent.[216] Admittedly, federal incorporation of insurance companies does not exempt them from provincial regulation, but in practice, in view of the heavy reliance of provincial regulators on federal supervision, it offers them substantial relief from repetitive regulatory requirements.

Third, until recently, provincial insurance, mortgage loan, and trust companies legislation has been substantially uniform. In the case of the insurance industry, the work of the Association of the Superintendents of Insurance, the Insurance Bureau of Canada (IBC), and the Canadian Health and Life Insurance Association (CHLIA) has also been an important vehicle for promoting uniformity. In the securities area, a similar function has been played by the regular meetings of provincial securities administrators and their adoption of uniform policy and national policy statements. No less important, because of its pre-eminence in the securities markets, Ontario has been able to provide leadership and, together with Quebec and Alberta, to promote de facto uniformity among many of the provincial securities regimes.

Fourth, most of the large near-banks are members of the CPA and are therefore subject to a common set of rules for clearing paper-based instruments and are common users of the electronic methods for the transfer of funds that are rapidly replacing the older system. With the exception of Quebec-based institutions and credit unions in other

provinces, these near-banks are also subject to federal regulatory influence through their membership in the CDIC.

Fifth, several of the smaller provinces have delegated their supervisory powers over insurance, trust, and loan companies to the federal government. In other cases, because of manpower inadequacies and lack of expertise, the degree of supervision at the provincial level may be quite perfunctory.

Finally, credit union operations at the branch level have not hitherto presented significant interprovincial problems, though this could change in the face of shared automated tellers and rapidly advancing computer technology.

Impact of new developments

The above factors help to explain why the untidy division of legislative and regulatory authority in Canada has not caused greater problems in practice than might otherwise be expected. However, the past is not a safe guide in responding to the regulatory challenges presented by current and future developments in the financial industry:

1 The new developments seriously disturb existing equilibria and require both federal and provincial authorities to move substantially in tandem if confusion, uncertainty, and competitive jockeying for position among the provinces and between the provinces and the federal government are to be avoided.

2 With rare exceptions, the challenges – both in terms of deregulation in some areas and the need for strengthened regulation in others – are national in character and cannot be resolved on a province-by-province basis.

3 The number of insolvencies in diverse sectors of the finance industry has disclosed significant inadequacies in existing laws and in the supervisory regimes for financial institutions at both the federal and provincial levels.

4 The heavy infusion of taxpayers' funds through the CDIC, the Bank of Canada, and other public sources to rescue insolvent financial institutions and to repay depositors creates new tensions between different types of financial institutions and between the federal and

provincial governments and makes it politically important for the federal government to strive for national regulatory standards.

The federal Green Paper proposals[217] for a federal financial holding corporation (FHC), while a stimulating starting point for discussion, may accentuate rather than relieve the regulatory imbroglio in the absence of broad federal-provincial consensus. This is because:

1 The Quebec thrust (as reflected in Bill 75)[218] is towards a more direct form of deregulation.

2 Some provincial authorities may resist a federal attempt to impose common regulatory standards (e.g., with respect to self-dealing, conflicts of interest, financial returns) on provincially incorporated institutions forming part of the new financial conglomerates.

3 Constitutionally, the federal government may not be competent to impose common regulatory standards on provincially incorporated subsidiaries of the FHC.

4 The federal proposals do not address themselves to the multiplicity of regulatory laws and regimes in Canada, nor do they resolve existing provincial differences (e.g., between Ontario and Quebec) over institutional and foreign ownership of securities dealers. (In fact, only Ontario and Saskatchewan currently impose foreign ownership restrictions.)

5 The federal proposals, even if implemented in their present form, will not prevent the creation of provincially sanctioned FHCs without the benefit of banking subsidiaries. Some well-known conglomerates (embracing non-financial as well as financial affiliates) already exist, and the federal proposals may encourage the growth of new ones to avoid what may be perceived to be the more restrictive federal regulations.

PROSPECTS FOR HARMONIZATION

Background

The preceding review illustrates the wealth of federal and provincial regulations administered by a large group of regulatory authorities

that has developed into a complex (though not necessarily comprehensive) regulatory framework. The evolution of that framework is distinguished by a remarkable lack of conscious planning or, with the exception of regulation of the insurance industry, competition for regulatory jurisdiction. As a result, the basic regulatory patterns that prevail today, after up to a century of market changes, developed in response to a world that no longer exists. This, in large measure, flows from the reactive nature of regulation that has evolved largely in response to industry demand and/or discrete market failures.

The potential scope of federal and provincial constitutional jurisdiction is difficult to surmise where, as in this patchwork quilt of regulations, powers have been defined largely by historic precedent or by default. The regulatory framework certainly does not evince any coherence from a constitutional perspective. Regulatory (as well as market) functions have been neither segregated nor allocated rationally. Moreover, while the regulatory framework is currently subject to active review, the primary focus is on institutional design rather than on the question of constitutional powers per se.[219]

There is, however, with the benefit of hindsight, a general consensus on the public policy concerns that underlie regulation of the financial services sector. One general area relates to concentration of power, self-dealing, and conflicts of interest. Regulation of the financial services industry has been shaped largely by economic doctrine. Policy makers have been persuaded that an unregulated financial sector would lead to dominance by a few large institutions, and, as a result, regulatory policy has evolved to keep the economic power of financial institutions relatively dispersed. To date, policy makers have been persuaded that the mandatory separation of certain financial services is an effective (or, at least, highly visible) regulatory response, as well as a way to facilitate regulating against abuses of self-dealing and conflicts of interest.

The public policy concern that currently enjoys the most political currency relates to ensuring the solvency of financial institutions. This is interpreted broadly to include liquidity risks (i.e., the chance that customers will not be able to withdraw funds on demand or when their deposits come due), and guaranteeing consumers against loss in the case of financial collapse (i.e., the liabilities of the failed institution exceeding its assets). Regulatory responses include rules concerning the form of organization, audit and capital requirements, and

standards concerning investments, as well as deposit insurance and other forms of guarantee funds.

The traditional rationale for regulation in any market is consumer protection. This concern is particularly relevant to financial services, where consumers are relatively ignorant about the services being purchased and the markets in which they deal. The inequality of bargaining position, the lack of information, and the complexity of the service being offered make it difficult for a consumer to ensure that he or she is being treated fairly. Public policy dictates disclosure requirements, contract standardization, and enforcement and fraud prevention measures, all designed to assure fairness and to prohibit defined practices that offend the community standard.

The most recent basis for regulation stems directly from the nature of the regulatory framework itself. Increasingly, regulators are called upon to be mindful of competitive inequities arising from inconsistent regulatory treatment, either from one jurisdiction to the next or from one type of financial institution to the next. Demands for a 'level playing field' have become the rhetoric of lobbying for regulatory reform – be it the removal of regulatory burdens not currently imposed on competitors or the imposition of additional regulatory constraints on such competitors to equalize their position. Ideally, any firm should succeed in the marketplace because of price and service, rather than by virtue of regulatory provisions that give it an artificial advantage over different types of competing firms.

To the extent that regulatory reform has occurred of late, it has been primarily in response to an erosion of competitive barriers and the rapid integration of new technology in the marketplace, rather than the deliberate design of policy makers. In this context, 'proactive re-regulation' or deregulation may no longer exert more than a marginal influence, because the existing regulations no longer impose significant constraints on the economic decisions that are being made in the marketplace. Many have observed that when the regulatory structure for the financial services industry finally begins to take shape, it will simply confirm what already exists.

Harmonizing federal and provincial legislation and regulation

Both the federal Green Paper and the Interim Report of the Ontario Task Force on Financial Institutions have emphasized the importance of harmony in the federal and provincial responses to the new regu-

latory challenges, and there must surely be few individuals who would not subscribe to what has become a motherhood principle. It is now all too obvious that the regulatory challenges transcend provincial – indeed, international – boundaries, and that only by a combined application of their resources and constitutional powers can the federal and provincial governments hope to develop a national blueprint.

First, government policy makers must determine to what extent traditional institutional boundaries should be retained and how quickly and in what directions the existing barriers should be dismantled. Second, they must determine what new safeguards are necessary to protect the consumer interest and the larger public interest in terms of the existing institutional structures and in the context of future changes. Third, the federal and provincial regulators must agree on the allocation of legislative responsibility and the dovetailing of statutory responses so as to achieve optimal effectiveness in their common strategies. Finally, and at least as important as the third challenge, is the need for agreement on the principles that should guide supervisory regimes in the new era and how supervisory responsibilities should be allocated between the two levels of government.

We do not pretend to have ready answers to any of these questions. Instead, we put forward some short-term and long-term suggestions that seem worthy of consideration. If some appear unduly ambitious or idealistic, the fact that they should be so perceived is itself a further measure of the challenges that face federal and provincial policy makers.

One possible solution is a constitutional amendment to reallocate existing regulatory powers between the federal and provincial governments, particularly in relation to banks and banking. We see two major and probably insurmountable difficulties in following this route. The first is in determining how the powers should be reallocated between the two levels of government. An economist might well argue that we are dealing with a seamless web and that Canada must have an integrated statutory regime governing all financial institutions however they are denominated. This clearly points to a predominant, if not exclusive, role for the federal government. This solution may be expected to be unacceptable to a majority of the provinces. They would see it as involving an abdication of existing provincial powers without their receiving a *quid pro quo*. The federal

government could moderate its proposal and seek only the right to regulate all deposit-taking institutions. Functionally, this compromise would make little sense. Leaving this objection aside, it would also still require a major concession from the provinces. So its prospects are equally poor.

The second difficulty facing the constitutional amendment route lies in attracting sufficient support among the provinces to satisfy the new procedural requirements in the Constitution Act: two-thirds of the provinces representing at least 50 per cent of Canada's population. Even if these threshold figures can be met, there remains the further difficulty that a dissenting province would be entitled to opt out of the amendment, which would then not be binding on that province. The possibility of this happening would make the whole constitutional exercise largely futile.

Another possible approach – but one we view as being only slightly more realistic than constitutional amendment – is for the federal government to brave the gods and seek to persuade the courts that it already has the paramount jurisdiction effectively to regulate the near-banks as well as the institutions formally incorporated as banks under the Bank Act. In view of past precedents, this would be a formidable hurdle indeed. The federal government could try to distinguish them by limiting its asserted jurisdiction to the interprovincial operations of the near-banks, thus allowing it to invoke the constitution's trade and commerce clause (91[2]) or, rather more tenuously, the power to regulate interprovincial works and undertakings (92[10][a]). Still more ambitiously, the federal government might seek to argue that the unijurisdictional regulation of financial institutions is now of such national importance that it should be recognized as falling within the residuary power of the federal government to make laws for peace, order, and good government. The prospects of success for such an argument are negligible.

The trade and commerce power, if confined to interprovincial operations, offers the most fruitful approach. It derives support from Justice Estey's important dicta in the Supreme Court of Canada's decision in *Multiple Access*[220] almost inviting the federal government to use this route to regulate interprovincial and international dealings in securities. Nevertheless, so long as other alternatives are available, the federal government would be ill-advised to pursue this approach. Even if successful, all this route would demonstrate is that

the federal government has divided jurisdiction with the provinces in the securities area and over nonbanking financial intermediaries. It would compound, and not resolve, the existing jurisdictional difficulties. Instead of giving Canada an integrated financial institutions law, it would provide us with a mirror image of the jurisdictional problems that faced the federal and provincial governments in the farm products, motor carrier, and energy supplies areas before the two levels of government agreed on complementary legislation.[221]

Given these and other precedents, co-operative action between Ottawa and the provinces provides the best recipe for success in overcoming the jurisdictional hurdles, if not immediately, then at least on a medium-term basis. This approach has some distinct advantages. It is not confrontational, it does not require unreciprocated concessions, and all parties have ample incentive to agree on a harmonious formula. No less important, there are no insuperable constitutional difficulties. While current constitutional theory does not permit either level of government to abdicate its legislative authority in favour of the other,[222] it is equally well settled that there may be interdelegation of administrative authority between the federal and provincial governments as well as conditional legislation and legislation incorporated by reference.[223]

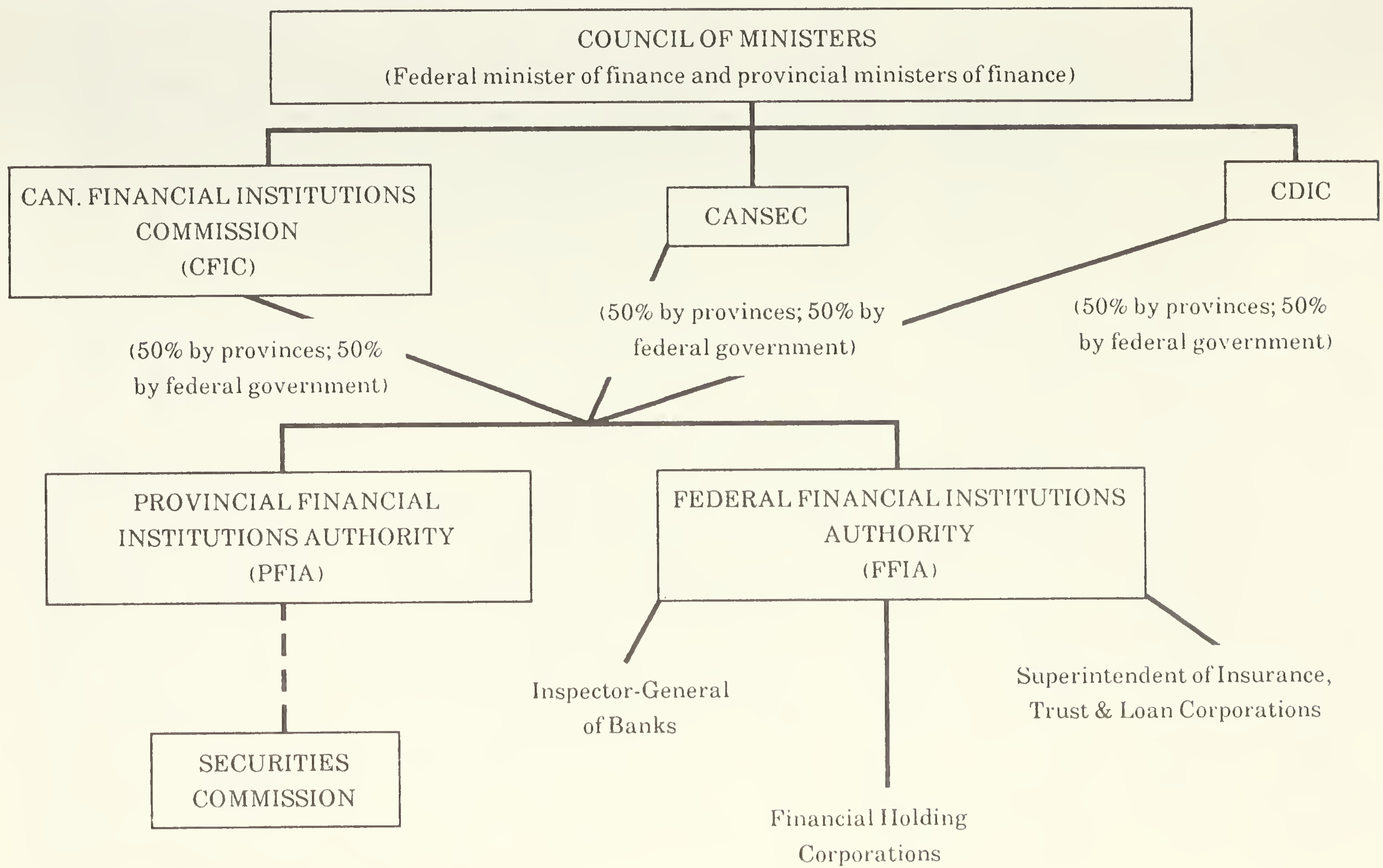
If it is agreed that the combining of legislative and regulatory powers by the federal and provincial governments provides the best strategy, then it remains to consider the modalities of such co-operation. Having regard to the pervasive character of the problems, the objective should be a reasonably integrated legislative and administrative scheme. Such a scheme should embrace all the major types of financial institutions and transactions, regardless of the place of incorporation of a particular institution, the number of provinces in which it carries on business, and whether or not it is affiliated with a holding corporation.

A model for agreement

In Figure 1, we present one possible model for such a co-operative scheme. Its governing feature would be a Council of Ministers. The Council would comprise all the provincial finance ministers or treasurers and the federal minister of finance. It would be responsible for approving uniform legislation in all areas in which the federal and provincial governments have concurrent jurisdiction (i.e., the incor-

FIGURE 1

Structure of federal-provincial financial institutions agreement



poration and regulation of trust and loan companies, insurance companies, credit unions, financial holding corporations, and the securities market). The Council would also appoint the members of the following newly established commissions:

- Canadian Financial Institutions Commission (CFIC).
- Canadian Deposit Insurance Commission (CDIC).
- Canadian Securities Commission (CANSEC).

Membership on these commissions would be equally divided between the federal and provincial governments. The Council would be responsible for resolving any jurisdictional issues between the commissions. Save as otherwise provided in the enabling legislation, decisions by the Council of Ministers and within each commission would be made by majority vote.

Subject to the Council of Minister's direction, the CFIC would be responsible for the drafting of uniform and other legislation to govern the financial areas other than those which are the responsibility of the CDIC and CANSEC in their respective spheres of authority.

As a third tier of authority in the proposed model, the two levels of government would create a Provincial Financial Institutions Authority (PFIA) and a Canadian Financial Institutions Authority (CFIA). These two bodies – a PFIA for each of the provinces and the CFIA at the federal level – would administer the provincial and federal legislation (uniform and otherwise) subject to the general supervision and directives of the three commissions. Interdelegation of administrative and supervisory powers between the federal and provincial agencies would continue to exist and would be encouraged. While it is important that supervisory powers over financial institutions at each level of government be consolidated in one agency (a feature envisaged for federal purposes in the Green Paper and already implemented, in part, at the provincial level in Ontario), some provinces may prefer to retain the relatively autonomous character of their securities commissions. There should be no objections to this so long as the boundary lines are clearly drawn and there is no duplication of functions. In the alternative, it may be preferable to link the provincial securities commissions directly with CANSEC along the lines envisaged in the original Cansec proposals. We have not thought deeply about this and remain uncommitted on the issue.

Subject to some exceptions mentioned hereafter, the above model emphasizes legislative and administrative integration for the full range of financial institutions. It is also implicit in the model that federally incorporated financial institutions would be entitled to operate provincially without requiring a separate licence and without being subjected to additional legislative or administrative requirements. The same dispensation would be extended to provincially incorporated institutions operating in other provinces.

Our model may appear overly ambitious and perhaps, if its soundness otherwise commends itself, it should be implemented incrementally on a sectoral basis. We would emphasize, however, that the pace of market developments is such that there may not be time for delay if Canadian regulators wish to implement a common regulatory regime. We have already referred to earlier models of federal-provincial co-operation in non-financial areas, and it may be helpful to expand on two that directly affect the securities fields and that may cast some light on the feasibility of our proposals.

The Cansec proposals, advanced by the Ontario Securities Commission in 1967,[224] also envisaged a three-tiered structure – a Council of Ministers, a national securities commission with regional and local offices, and a director at the central office as well as associate directors at each regional office and at certain local offices. The weakness in the proposals was that they were aimed only at administrative integration of the securities legislation; they did not postulate a uniform securities act and thus potentially placed the Commission in the invidious position of having to administer diverse acts with conflicting policies. From the provincial point of view, the proposals were also unattractive because they conceded a new role for the federal government in an area in which it had not previously sought to inject itself. We feel that our model is free from both these objections, although it may be open to others.

Of particular interest to Canadians is the agreement reached 28 December 1978 between the Commonwealth Government of Australia and the Australian states on co-operative companies and securities industry legislation and its administration. In Australia, as in Canada, jurisdictional competence in matters of company law and securities regulation is divided between the two senior levels of government. The states agreed on a uniform companies act in 1961, but there was no comparable agreement on uniform securities legislation.

Moreover, the uniform companies act quickly became dated because of new corporate developments and non-uniform amendments adopted by individual states. In 1974, the states were also faced with the threat of separate Commonwealth companies and securities legislation. The states were anxious to avoid such a threat, and this led to a protracted period of negotiations between the state and Commonwealth governments resulting in the agreement of December 1978 for the establishment of a national scheme. The important components of the scheme are the following:[225]

1 The introduction of uniform and co-operative legislation by the Commonwealth, states, and participating territories.[226]

2 The establishment and operation of a ministerial council of Commonwealth and state ministers to approve the uniform legislation as well as any amendments and additions, and to formulate and direct policy.

3 The establishment and operation of a National Companies and Securities Commission (NCSC) to administer the national scheme. Its members are appointed by the ministerial council. So far as possible, the commission is apparently expected to delegate its powers to the corresponding body or official in each state and participating territory.

4 The continuation of existing state and territory corporate affairs administration subject to the direction and overriding jurisdiction of the NCSC.

The Australian scheme is now in effect, though we have no first-hand knowledge about its operational experience. The scheme is considerably more extensive than were the Cansec proposals; it also avoids the dual legislative regime envisaged by the Cansec proposals. However, it does not match our model in ambitiousness since it is restricted to companies and securities legislation.

While we feel we are on solid precedential ground in at least putting forward our model for discussion, fairness also requires us to draw attention to some of its weaknesses and limitations beyond those to which we have already adverted. One obvious weakness is the apparent lack of political accountability of the different components of our scheme. We would respond that the problem is an old one, that it

arises with many other federal-provincial co-operative arrangements, and that in fact our model provides adequate opportunities for political review and public accountability. We suspect in any event that most voters, as well as shareholders in financial institutions and their depositors, would be much more concerned about the effectiveness of the scheme than about their ability to subject it to direct and minute scrutiny.

From a provincial perspective, a more significant weakness of our model may reside in its failure to make clear to what extent the federal Bank Act and other non-concurrent exercises of federal power would be subject to review and approval by the Council of Ministers. The same ambiguity surrounds the powers of the proposed Canadian Financial Institutions Commission. Ideally, the federal government's banking power should be integrated into the model. However, we recognize that it may be unrealistic to expect the federal government fully to share with the Council of Ministers and the Commissions a power that it has exercised exclusively from the earliest days of Confederation. In any case, it should be possible to reach a compromise that would require the federal government at least to consult the Council before making any significant changes in the Bank Act.

We feel confident that a solution can be found to the problem, since the federal government will appreciate that the provincial governments will refuse their consent to uniform legislation in the non-banking area if the federal government is uncooperative on the banking legislation. Co-operation between the two levels of government will also be essential if there is a general consensus in favour of the argument of economists that financial activities should be regulated along functional and not institutional lines. Another ground for optimism is that it is in the interests of all parties to find an acceptable formula for the regulation of deposit-taking institutions. This is because depositors expect to be protected against institutional insolvencies regardless of where the institution is incorporated or who is responsible for its supervision. Likewise, as recent events demonstrate, a loss of confidence in one type of depository insurance can easily spill over into another type.

Near-term co-operation

Constitutional issues posed by the regulation of the financial services sector must be viewed in the context of a rapidly evolving market

environment. While there is considerable debate about the means of regulatory reform, ranging from increased reliance on competition to a variety of different forms of regulation or configurations of regulators, constitutional issues generally surface in the form of homilies to harmonization rather than specific proposals for reform or direct challenges to the jurisdiction of others.

The recent experience of the CDIC in responding to a rapid succession of financial institution failures illustrates the capacity for ad hoc interjurisdictional co-operation in response to market crises. Neither level of government could afford the perceived threat to public confidence in the integrity and stability of the financial system. The CDIC was able to exercise, with the consent of provincial regulators, wide-ranging powers which, had the provinces been inclined, could have been challenged from a constitutional perspective.[227]

While co-operative responses to crises may pave the way for ongoing co-ordination and co-operation between regulators, there is little reason to anticipate wholesale rationalization of the regulatory framework in this manner. Indeed, regardless of the availability of constitutional tools to effect regulatory reform, its likelihood in the immediate future (other than by incremental compromise and co-operation) is remote unless the major competing financial institutions unite in its support. In the current market environment, economic incentives are sufficient to cause firms to devise means to avoid regulatory restrictions. We may well wait until the market approaches an equilibrium position before the mutual desire of competing financial institutions to diversify into each other's products and services, without resorting to the costly devices of clever lawyers, provides the impetus for deliberate re-regulation.[228]

While regulatory co-ordination and co-operation are more typically achieved in response to market crises, there are instances where it can be implemented in anticipation of market developments, particularly where a common cause unites one or more elements of the financial services sector. The co-operative development of clearing and settlement systems, first at the national level and more recently internationally, is one example. Even here, however, one should guard against exaggerated expectations about the scope for significant regulatory or organizational reform. To the extent that regulation serves to preserve the status quo by attenuating change (though never completely stopping it as long as there are adequate incentives),

wholesale organizational reform, at either the regulatory or market levels, is unlikely.[229]

Discounting the scope for significant organizational reform, at least at the regulatory level, does not invalidate the desire to develop and agree upon criteria for the rational distribution of regulatory responsibilities. While the sensitivity to local and regional concerns implicit in territorial regulation remains an important factor, the spatial dimension has become less relevant to market actors and regulators with the advent of new communications technology.

There remain, however, a number of regulatory criteria that have continuing relevance. Such criteria would include the desire to maximize regulatory effectiveness and, perforce, minimize inadvertent regulatory overlaps, duplications, and inconsistencies. To the extent that regulatory differences are widening in areas of shared jurisdiction, these criteria suggest the need for immediate measures to adopt 'forum shopping' as a device for relaxing regulatory standards.[230] Another continuing objective is to ensure effective representation and political accountability in any regulatory framework. Finally, recognizing that regulation predominantly responds to, rather than anticipates, market developments, it is important that any regulatory framework be sensitive to the markets it purports to govern.

While it may be relatively simple to identify and even agree upon relevant regulatory criteria, the foregoing analysis suggests it is probably safe to assume that institutional (rather than functional) regulation will continue to be the norm in Canada, at least until the market transformation currently taking place within the financial services sector reaches greater maturity. Meanwhile, the primary focus of demand for functional regulation will relate to competitive equity concerns, which can be addressed by achieving equivalent standards for differently regulated institutions. Over the near term, this can probably best be achieved by incremental efforts to co-operate and co-ordinate regulatory standards, rather than by seeking implementation of any specific institutional model addressing the allocation of responsibilities between levels of government (or even between branches of the same government). Indeed, as regulators resign themselves to the fact that the marketplace is outpacing existing regulatory frameworks, a mutual desire to avoid gaps, duplication, and disparate regulatory standards should encourage closer co-operation and liaison between agencies and between different levels of

government in an effort to achieve a common view on regulatory objectives and policy approaches. In this regard, several models bear consideration.

The mutual desire of competing institutions to achieve consistent standards always suggests an opportunity for uniformity. The mutual fund industry provides a good example. In 1965, the provincial securities administrators recommended that a joint federal-provincial study of mutual funds be undertaken. This recommendation was accepted at a first ministers meeting in 1966, and the Canadian Committee on Mutual Funds and Investment Contracts was constituted. Its report was published in 1969,[231] and the provincial administrators readily agreed that the majority of the recommendations relating to regulatory standards should be implemented. The Ontario Securities Commission was instructed to review the report in a provincial context and make specific recommendations to the other administrators as to how they should implement standards. In relatively short order, uniform policy (and, in due course, legislation) was adopted.

The development and harmonization of regulatory standards responded to and facilitated the rapid growth of the mutual fund industry in Canada. A relative paucity of pre-existing regulations facilitated the task of harmonization as did industry demand and, perhaps, the prospect of federal regulation in default of inter-jurisdictional accord.

While the substantive recommendations of the Canadian Committee on Mutual Funds were adopted in short order, its suggestions relating to the administration of the regulatory scheme have not enjoyed similar success. The report assumed that there would be a period of time after the implementation of its substantive recommendations during which separate administration (based on the allocation of responsibilities between securities and trust/insurance company administrators) would continue. The report, however, suggested ultimately consolidating regulation of trust, life insurance, and investment contract companies within a single branch or agency of each government. Over the longer term, the report anticipated the development of a 'national administrative agency,' which has yet to materialize. Similarly, the report's anticipation of the development of a scheme for self-regulation in the mutual fund and investment contract industries has not advanced to the extent anticipated.

Uniform policy making among provincial securities administrators flourished for several years following publication and implementation of the report of the Canadian Committee on Mutual Funds and Investment Contracts. Subsequently, additional policies (and legislation) have been developed in a co-ordinated fashion, largely through the biannual meetings of the Canadian securities administrators. Such meetings are also attended by representatives of the various self-regulatory organizations within the securities industry.[232]

Co-operative intergovernmental regulatory policy can be achieved in response to market crises and competitive equity concerns. In respect of the former, the experience of the CDIC (and, in response to recent institutional failures, both governments and the private sector)[233] should provide lessons for further co-operation. In respect of the latter, the development of uniform national and local policies by Canadian securities administrators, largely in response to constituency demand, illustrates the manner in which competitive equity concerns may be addressed. For example, the first national policy adopted was designed to facilitate the filing of prospectuses by enabling an underwriter to deal with all the provinces through a single provincial administrator while, at the same time, preserving the autonomy of each of the provincial securities administrators.

Beyond co-operation, consideration should be given to the consolidation of regulatory and supervisory authority within a single administrative agency or branch at any particular level of government. If implemented, the proposal in the federal Green Paper to consolidate the functions of the Inspector General of Banks and the Department of Insurance in a comprehensive supervisory body, using computer technology to facilitate the regulatory task, would promote further harmonization, if only by virtue of the predominant influence of the resulting regulatory body.

The near-term utility of self-regulatory agencies to respond to the challenges of complexity and integration also bears further consideration. The advantages of self-regulation in the financial services sector are obvious. Members in the component industries have the greatest familiarity with the ways in which they operate, as well as the keenest awareness of the costs of excessive or misguided regulation. The reputable members of each industry have perhaps the greatest interest in the elimination of deceptive or unfair practices engaged in by their less scrupulous competitors.

At the same time, self-regulation exhibits certain weaknesses. The zeal of the self-regulators may flag when they are faced with practices that are widespread in the industry rather than confined to a few fringe operators. Their desire to preserve the image of the industry may conflict with the need for vigorous enforcement. Certainly, the vigour of enforcement is likely to suffer unless there is a realistic alternative of direct government intervention if self-regulation proves ineffective. Moreover, while self-regulation can address concerns about solvency and consumer protection, it is not suitable to address problems of concentration or other issues relating to the economic regulation of the financial services sector. Government oversight is also essential here to maintain a proper balance between the regulatory and promotional objectives of a self-regulatory body.

While limited in its ability to resolve competitive intersections, self-regulation has proved effective in bridging the co-operative intersections within the financial services sector – particularly, as noted above, those involving proficiency standards and the clearing and settlement of transactions. Whatever merits government regulation may have as a means of preventing people from engaging in proscribed activities, it is generally ineffective as an incentive for people to improve their performance in permitted activities. In such instances, the 'carrot' approach of self-regulation is preferable to the 'stick' of government regulation.

Driven by economies of scale in fund management and distribution and in the electronic and mechanical aspects of clearing, many institutions will be unable to enter new markets independently or to offer their old services competitively in their old markets. It appears that, at least in the near term, one competitive response will be the sharing of product offerings or the resort to contractually arranged franchise services in lieu of branching (referred to generally as networking). Here, too, given adequate competition rules, self-regulation may prove the best starting point for developing an effective and harmonious regulatory framework.

In the near term, self-regulation is also more easy to achieve than are various proposals for administrative interdelegation. While self-regulatory organizations are commonly responsible to a single overseeing agency, this is not a necessary stricture.[234] While self-regulatory organizations have been, and likely will continue to be, institutionally oriented, there is no reason why they could not bridge

several traditional institutions, or be accountable to a number of different overseeing bodies.

One interesting model was adopted in the United States to regulate dealers in municipal securities. In 1975, the Securities Exchange Act was amended to require these dealers (including a large number of banks) to register thereunder.[235] However, rather than simply subject them to SEC rule-making and enforcement powers, Congress established a special scheme reflecting the unique characteristics of the industry. The rules governing trading in municipal securities are written not by the SEC but by a fifteen-member Municipal Securities Rule-Making Board (MSRB),[236] of whom five members must be associated with bank dealers, and five must not be associated with any broker or dealer. The original members of the MSRB were selected by the SEC, while replacement members are elected by the continuing group. Enforcement powers with respect to non-bank dealers are vested in the SEC and the National Association of Securities Dealers Inc.(NASD). With respect to banks, enforcement efforts require co-ordination between the SEC and the appropriate bank regulatory agency.

While this arrangement appears rather cumbersome, the special mix of MSRB members seems to have made it sensitive to the needs and problems of the industry in formulating its regulations. Moreover, it is not clear that any of the alternative agencies were in a better position to administer or supervise a scheme of regulation for this unique and important market. Serious consideration is now being given to expanding the mandate of the MSRB to include regulation of the US government securities market in the wake of the widely publicized failures of several small dealers over the past several years.[237]

Such a concept of self-regulatory organizations subject to multiple oversight could achieve various objectives. For one, the nonlegislative approach has the advantage of avoiding some of the difficulties and delays inherent in the enactment of any new kind of legislation. Multiple oversight can ensure accountability and effective representation at all appropriate levels of government. Meanwhile, the self-regulatory organization can achieve a degree of integrated regulation and also maintain a high degree of market sensitivity at a level removed from the political process. Self-regulation also allocates the costs of regulation directly. Perhaps most significantly, the

increasing complexity of the financial services sector may require self-regulation in light of the limited capacity of government agencies and legislatures to keep pace with market innovations.

Calls for self-regulation are beginning to emerge. For example, the vice-chairman of the Federal Reserve Board in the United States recently called on banks to establish a self-regulatory system to ensure the industry's safety and soundness. In an address on 11 April 1985,[238] he labelled the proposal a 'radical notion', and cited the precedents of peer review systems in the accounting, nuclear power, and securities industries. Similarly, recent regulatory reform initiatives in the UK, both public and private, have placed considerable emphasis on self-regulation.[239]

CONCLUSION

Emerging regulatory processes must accommodate the likelihood that regulatory issues themselves may change dramatically as the marketplace changes. For example, the structure of the financial services sector will probably be based on regulated holding companies with separate 'functional' subsidiaries. While it may be argued that such a structure will decrease risks to the overall system by allowing financial firms to diversify their earnings and spread costs, key regulatory issues concerning competition and self-dealing, as well as the extended jurisdictional competence of regulatory bodies to govern such holding companies, must be considered.[240] These are the issues that the federal Green Paper begins to identify and address. The fact that, with the exception of the insurance sector, industry response has been generally negative (or, at least, reserved) indicates the complexity of the issues.[241]

Another emerging issue relates to the potential regulatory hazards posed by combining financial and commercial institutions. The concern is not new, having been the subject of a 101-volume study[242] by the US Federal Trade Commission, which led to the passage of the Public Utility Holding Company Act of 1935 (the Holding Company Act).[243] The hazards referred to in the Act include write-ups of assets, unsound pyramid financing, extraction of excessive dividends and service charges to maintain highly leveraged holding company structures, improper accounting practices, undue favouring of affiliated investment banks in the public distribution of holding company stock, and concentration of economic power. The Act subjects holding

company systems to SEC registration, geographical integration, and corporate simplification requirements.[244]

Similar concerns regarding bank involvement in the non-financial sector were voiced by the Porter Commission in 1964:

> We also believe it desirable to clarify Section 75(2)(b) of the Bank Act which prohibits a bank from directly or indirectly dealing in goods, wares or merchandise or engaging in any trade or business. The purpose of this change is primarily to ensure that banks do not over-extend themselves in fields in which they are not expert but it also acts to prevent extensive banking control of other businesses. We therefore recommend that a banking institution should be prohibited from holding more than 10% of the stock of any non-financial business . . . In a related area, we believe it unwise and undesirable for the executive officers of banking institutions to serve as directors of other commercial concerns . . . but we do not feel that this practice warrants a legislative prohibition.[245]

The concerns that gave rise to the US Holding Company Act have been the focus of a more general policy debate in Canada since the bid for control of Argus Corporation by Power Corporation in early 1975.[246] At the November 1984 hearings convened by the Ontario Securities Commission to consider its regulatory framework governing entry into and ownership of the Canadian securities industry, the industry committee argued the desirability of maintaining ownership restrictions to ensure that securities firms not become part of, or subject to undue influence by, a conglomerate.

In order to address these emerging issues, new fields of research should be encouraged. For one, traditional notions of markets in the financial services sector need to be re-thought. Regulatory concerns about competition and concentration of power cannot be adequately studied with current market-related data and analytical tools.

Similarly, research into the limits of regulation should be encouraged. There is a growing recognition that the financial services marketplace is growing too complex, diverse, international, and fast-changing to be effectively regulated by any government. Research may suggest that the focus for regulatory reform should be shifted, to international or other regulatory instruments (i.e., competition policy).

As the future unfolds, it will be clear that, given the political will, constitutional tools are available to achieve harmony between federal and provincial legislation and its administration. It is also only realistic to recognize that full integration will come only slowly (if at all) and that near-term and medium-term alternatives must be pursued in the mean time. These alternatives should make full use of existing resources while not imposing any restrictions on the play of market forces that are not dictated by the consumer interest or generally accepted as national economic goals.

NOTES

1 *Constitution Act, 1867*, 30-31 Vict., c.3 (UK); formerly known as the *British North America Act, 1867*.
2 B. Laskin (1966) *Canadian Constitutional Law* rev. 3rd ed. (Toronto: Carswell) p. 603.
3 P. Hogg (1984) *Constitutional Law of Canada* 2nd ed. (Toronto: Carswell) pp. 370-2.
4 *Ibid.*, at pp. 242 and 296.
5 *Citizens' Insurance Co.* v. *Parsons* (1881), 7 App. Cas. 96 (PC), at p. 113.
6 See, for instance, P. Hogg, *supra* note 3, at pp. 267-8 and 299-302.
7 *A.-G. Ontario* v. *Policyholders of Wentworth Insurance Co.*, [1969] SCR 779. The case is discussed in more detail in P. Hogg, *supra* note 3, at p. 302.
8 *Canadian Pioneer Management Ltd.* v. *Labour Relations Board of Saskatchewan* (1980), 107 DLR (3d) 1 (SCC).
9 *Re Bergethaler Waisenamt*, [1949] 1 DLR 769 (Man. CA).
10 Lymburn v. *Mayland*, [1932] AC 318 (PC).
11 *Multiple Access Ltd.* v. *McCutcheon* (1982), 138 DLR (3d) 1.
12 *Gregory & Company Inc.* v. *Quebec Securities Commission*, [1961] SCR 584. The case is discussed in more detail in P. Anisman and P. Hogg, 'Constitutional aspects of federal securities legislation.' In P. Anisman, ed. (1979) *Proposals for a Securities Market Law for Canada*, 3 (Ottawa: Supply and Services) pp. 145-6.
13 *R.* v. *W. McKenzie Securities Ltd.* (1966), 56 DLR (2d) 56. This case is also discussed in greater detail in P. Anisman and P. Hogg, *supra* note 12, at p. 145.
14 P. Hogg, *supra* note 3, at p. 517.

15 *Bonanza Creek Gold Mining Co.* v. *The King*, [1916] 1 AC 566 (PC).
16 *Tennant* v. *Union Bank of Canada*, [1894] AC 31, *per* Lord Watson at p. 46.
17 *Canadian Pioneer Management Ltd.* v. *Labour Relations Board of Saskatchewan*, *supra* note 8, *per* Beetz J. at p. 20.
18 I. Baxter (1981) *The Law of Banking* 3rd ed. (Toronto: Carswell) at p. 197.
19 *Canadian Pioneer Management Ltd.* v. *Labour Relations Board of Saskatchewan*, *supra* note 8, *per* Beetz, J. at p. 20.
20 *Re Bergethaler Waisenamt*, *supra* note 9, per Richards, J.A. at p. 776 and *per* Coyne, J.A. at pp. 778-9.
21 I. Baxter, *supra* note 18, at p. 197.
22 *Canadian Pioneer Management Ltd.* v. *Labour Relations Board of Saskatchewan*, *supra* note 8, *per* Beetz, J. at pp. 24-6 and 28.
23 P. Hogg, *supra* note 3, at p. 532.
24 *John Deere Plow Co. Ltd.* v. *Wharton*, [1915] AC 330 (PC).
25 *Multiple Access Ltd.* v. *McCutcheon*, *supra* note 11.
26 *John Deere Plow Co. Ltd.* v. *Wharton*, *supra* note 24; *Multiple Access Ltd.* v. *McCutcheon*, *supra* note 11.
27 *Great West Saddlery* v. *The King*, [1921] 2 AC 91 (PC); *Churchill Falls (Labrador) Corp. Ltd.* v. *A.-G. Newfoundland* (1984), 8 DLR (4th) 1 (SCC).
28 *Canadian Indemnity Co.* v. *A.-G. British Columbia* (1976), 73 DLR (3d) 111, at p. 122.
29 See *supra* notes 5 and 6.
30 See *supra* notes 12 and 13.
31 See, for instance, *A.-G. Manitoba* v. *Manitoba Egg and Poultry Association*, [1971] SCR 689 (SCC) and *Burns Foods Ltd.* v. *A.-G. Manitoba*, [1975] 1 SCR 494 (SCC). These and the earlier marketing cases are discussed in greater detail in P. Hogg, *supra* note 3, pp. 440-3 and 310-12.
32 On this point, see P. Anisman and P. Hogg, *supra* note 12, at pp. 157-61.
33 *Citizens' Insurance Co.* v. *Parsons*, *supra* note 5, at p. 113.
34 P. Anisman and P. Hogg, *supra* note 12, at pp. 161-71.
35 *MacDonald* v. *Vapor Canada* (1976), 66 DLR (3d) 1. The case is discussed in greater detail in P. Hogg, *supra* note 3, at pp. 273-5.

36 *Dominion Stores Ltd.* v. *The Queen*, [1980] 1 SCR 844; *Labatt Breweries of Canada Ltd.* v. *A.-G. Canada* [1980] 1 SCR 914. These decisions are extensively analysed in J. MacPherson, 'Economic regulation and the British North America Act' (1980-81), 5 *Canadian Business Law Journal* p. 172.

37 *A.-G. Canada* v. *Canadian National Transportation Ltd.* (1983), 3 DLR (4th) 16, *per* Dickson, J. (Beetz and Lamer, JJ. concurring), at pp. 54-63. The majority judgement in the case, written by Laskin, C.J.C. (Ritchie, Estey, and McIntyre, JJ. concurring) did not find it necessary to deal with the issue.

38 *A.-G. Ontario* v. *A.-G. Canada*, [1896] AC 348 (PC), *per* Lord Watson at p. 361 (the Local Prohibition case). For a general discussion of the 'national concern' and 'national dimensions' aspects of the POGG power, see P. Hogg, supra note 3, at pp. 246-52 and 257-61.

39 *Reference Re Anti-Inflation Act*, [1976] 2 SCR 373.

40 See P. Anisman and P. Hogg, *supra* note 12, at pp. 177-86.

41 *A.-G. Ontario* v. *Policyholders of Wentworth Insurance Co.*, *supra* note 7.

42 See P. Hogg, *supra* note 3, at p. 460.

43 See, for instance, *Smith* v. *The Queen*, [1960] SCR 776 (SCC).

44 See P. Anisman and P. Hogg, *supra* note 12, at pp. 186-9.

45 *Ibid.*, at pp. 173-5.

46 *Ibid.*, at pp. 175-6.

47 *Ibid.*, at p. 176.

48 *Supra* note 12.

49 Royal Commission on Banking and Finance (1964) *Report* (Ottawa: Queen's Printer). Hereafter the Porter Commission Report.

50 *Ibid.*, at p. 364.

51 E.P. Neufeld (1972) *The Financial System of Canada* (Toronto: MacMillan) p. 36.

52 *Ibid.*, at p. 39.

53 *Ibid.*, at p. 43.

54 SC 1871, c.5.

55 The Montreal City and District Savings Bank is governed by the *Quebec Savings Banks Act*, RSC 1970, c. B-4, as amended. Savings banks were formed prior to Confederation in the Province of Canada, and only one remains today. Savings banks

differ from chartered banks in that their emphasis is on personal lending and their investment powers are limited so as to restrict unsecured commercial loans and to ensure the long-term safety of deposits.

56 D.J. Baum (1973) *The Investment Function of Canadian Financial Institutions* (New York: Praeger) p. 50.

57 First introduced as s.74 in SC 1890, c. 31.

58 See *An Act to amend the Bank Act*, 1900, 63-64 Vict., c. 26, and the Porter Commission Report, at p. 117.

59 Porter Commission Report, *supra* note 49, at p. 113.

60 Neufeld, *supra* note 51, at pp. 97-8.

61 Neufeld, *supra* note 51, at p. 106.

62 SC 1890, c.31.

63 Porter Commission Report, *supra* note 49, at p. 117.

64 *Bank of Canada Act*, SC 1934, c.43. The Bank of Canada was given exclusive authority to issue bank notes in Canada.

65 Neufeld, *supra* note 51, at pp. 107-8.

66 *Ibid.*, at pp. 109-10.

67 SC 1953-54, c.23.

68 SC 1953-54, c.48., s.75.

69 SC 1967, c.87.

70 Neufeld, *supra* note 51, at pp. 105-6.

71 SC 1967, c.87.

72 Porter Commission Report, *supra* note 48, at p. 372.

73 SC 1967, c.87, s.76.

74 See Baum, *supra* note 56, at pp. 54-7.

75 SC 1967, c.70.

76 See RSC 1970, c.C-3, s.16.

77 See RSC 1970, c.C-3, s.22.

78 Neufeld, *supra* note 51, at p. 111.

79 SC 1980-81-82-83, c.40.

80 SC 1980-81-82-83, c.40, s.173(1)(i) and (j).

81 SC 1980-81-82-83, c.40, s.193(5) and (6).

82 SC 1980-81-82-83, c.40, s.173(l)(m).

83 See ss.146, 146.2, and 146.3 of the *Income Tax Act* (Canada) as amended by SC 1980-81-82-83, c.40, Part V, ss.96-8.

84 SC 1980-81-82-83, c.40, s.190(5).

85 See J.H.C Clarry (1984) 'An overview of the Bank Act.' In *Important New Developments in Banking Law and Practice.* Seminar held 12-13 November 1984. (Toronto: Insight Press).
86 See the *Canadian Payments Association Act*, SC 1980-81-82-83, c.40, Part IV.
87 See *OSC Bulletin*, 31 October 1983.
88 See the *Globe and Mail*, Report on Business: 13 October 1984; 19 November 1984; 20 November 1984; 22 November 1984; 6 December 1984; and 12 January 1985.
89 Neufeld, *supra* note 51, at p. 290.
90 Neufeld, *supra note 51*, at pp. 290-5. *The Trust Companies Act*, RSC 1970, c.47 (1st Supp.), s.2, amended the act to provide for federal incorporation of trust companies by issuance of letters patent.
91 *Ibid.*
92 SO 1972, c.83; SO 1972, c.68; see Neufeld *supra* note 51, at p. 293.
93 Neufeld, *supra* note 51, at pp. 295-7.
94 SO 1897, c.37. Ontario passed *An Act respecting Loan Companies*, SO 1897, c.38, at the same time.
95 See, for example, *An Act respecting the Chartering of Trust Companies*, SO 1895, c.32.
96 Clarified in Ontario by *An Act respecting Loan and Trust Companies*, SO 1912, c.34.
97 Neufeld, *supra* note 51, at pp. 297-98.
98 See *Trust Companies Act*, SC 1914. c.55.
99 [1980] 1 SCR 433.
100 *Ibid.*, at p. 466.
101 *Ibid.*, at p. 440.
102 *Ibid.*, at p.441.
103 Baum, *supra* note 56, at p. 69, and Neufeld, *supra* note 51, at p. 299.
104 See RSC 1970, c.T-16, s.70, as amended by 1974-75, c.7, s.1.
105 See RSO 1980, c.249, s.118.
106 Federally regulated trust companies now account for about two-thirds of the assets of all trust companies in Canada. See Canada Department of Finance (1985) *The Regulation of Canadian Financial Institutions: Proposals for Discussion* (hereafter the Green Paper), at p. 58.

107 See s. 6.1 of the *Trust Companies Act*, added by RSC 1970, c.47 (1st Supp.) s.2.
108 See, for example, the *Trust Companies Act*, RSNS 1967, c.316, and *An Act respecting Joint Stock Companies*, SM 1976, c.255, Part XXIV (Trust and Loan Companies).
109 *Ontario Deposit Insurance Corporation Act*, SO 1967, c. 61, amended by SO 1967, c. 62. See now RSO 1980, c. 328.
110 See the *Quebec Deposit Insurance Act*, SQ 1967, c.73.
111 Baum, *supra* note 56, at pp. 91-92 and Green Paper, *supra* note 106, at p. 58.
112 Neufeld, *supra* note 51, at pp. 220-8.
113 Hogg, *supra* note 3, pp. 457-9.
114 *Citizens' Insurance Co.* v. *Parsons* (1881), 7 App. Cas. 96.
115 *Insurance Reference*, [1916] 1 AC 588.
116 *A.-G. Ont.* v. *Reciprocal Insurers*, [1924], AC 328.
117 *Re Insurance Act of Canada*, [1932] AC 41.
118 SC 1868, c.48.
119 Baum, *supra* note 56, at pp. 95-6; Neufeld, *supra* note 51, at p. 234.
120 SC 1875, chs.20 & 21; SC 1877, c.42.
121 Baum, *supra* note 56, at p. 96; Neufeld, *supra* note 51, at pp. 236-7.
122 Neufeld, *supra* note 51, at p. 237.
123 SC 1910, c.32.
124 Note that the Green Paper, *supra* note 106, at pp. 42-3, proposes the substitution of 'quantitative' restrictions for the traditional 'qualitative' investment restrictions currently imposed on insurance, trust, and loan companies.
125 SC 1932, c.46.
126 SC 1932, c.47.
127 Hogg, *supra* note 3, at p. 459.
128 See preamble to SC 1932, c.46.
129 See preamble to SC 1932, c.47.
130 *Reference re s. 16 of Special War Revenue Act*, [1942] SCR 429, special leave to appeal refused, [1943] 4 DLR 657 (PC).
131 Hogg, *supra* note 3, at p. 459.
132 See, for example, the Ontario *Insurance Act*, SO 1883, c. 15, the *Life Insurance Act*, SO 1884, c.20, and the *Insurance Corporations*

Act, SO 1892, c.39, which were consolidated into the Ontario *Insurance Act* by SO 1897, c.36.

133 Neufeld, *supra* note 51, at p. 233.

134 See *Canadian and British Insurance Companies Act*, RSC 1970, c.I-15, ss.150-5, as amended.

135 Baum, *supra* note 56, at pp. 100-1.

136 See the Green Paper, *supra* note 107, at p.58.

137 Neufeld, *supra* note 51, at p. 233.

138 Baum, *supra* note 56, pp. 92-5.

139 For example, the Laurentienne Group of general and life insurance companies is the largest shareholder of Montreal City & District Savings Bank, which, in turn, controls mortgage lender Credit Foncier and a small trust company; Alliance Compagnie Mutuelle d'Assurance-Vie holds 20 per cent of Trust Général du Canada while Standard Life Assurance Co. has a 10 per cent interest in that trust company; the Manufacturers Life Insurance Company holds the largest equity interest in Canada Trust Company; Mutual Life Insurance Company recently acquired the controlling interest in the Interior Trust Company.

140 SQ, 1984, c.22.

141 *Ibid.*

142 *Ibid.*

143 *Ibid.*

144 See *OSC Bulletin*, 31 October 1983.

145 *Lymburn* v. *Mayland*, [1932] AC 318.

146 See the Report of the Attorney General's Committee on Securities Legislation in Ontario (March 1965), at pp. 69-70 (hereafter the Kimber Report).

147 See J.S. Ziegel 'Constitutional Aspects of Canadian companies.' In J.S. Ziegel, ed. (1973) *Studies in Canadian Company Law*, 1 (Toronto: Butterworths), at pp. 167-71.

148 See P. Anisman and P. Hogg, *supra* note 12, at pp. 145-7.

149 *Ibid.*

150 *Gregory & Company Inc.* v. *QSC*, [1961] SCR 584.

151 See *R.* v. *McKenzie Securities Ltd.* (1966), 56 DLR (2d) 56. However, it was held in *Black* v. *Doherty McCuaig Ltd.*, [1947] 4 WWR 342 (BCSC), that a cease-trading order issued by the securities commission of British Columbia cannot preclude transactions in the same securities in Ontario. Similarly, the Alberta Gas

Trunk Line Company was able to purchase over one-third of the shares of Husky Oil Ltd on the American Exchange in 1978, notwithstanding bylaws of the Toronto Stock Exchange, recognized in the takeover provisions of the Ontario *Securities Act*, respecting maximum allowable market purchases in a thirty-day period. See P. Anisman and P. Hogg, *supra* note 12, at pp. 146-9 for a more complete discussion of this point.

152 Beginning with the English *Joint Stock Companies Act*, 1844, c.110. See generally, J.P. Williamson (1960) *Securities Regulation in Canada* (Toronto: University of Toronto Press) pp. 4-8; E.P. Neufeld, *supra* note 51, pp. 532-3; and D.L. Johnston (1977) *Canadian Securities Regulation* (Toronto: Butterworths) pp. 11-12.

153 See Williamson, *supra* note 152, at pp. 8-11.

154 SO 1891, c.34.

155 *Companies Act*, SO 1907, c. 34.

156 *Companies Act*, SO 1912, c.34.

157 See Williamson, *supra* note 152, at pp. 8-11.

158 SM 1912, c.75.

159 See Neufeld, *supra* note 51, at pp. 534-5.

160 Kan L. 1911, c.113.

161 Until 1914, the Act applied only to issuers, not incorporated or licensed in Manitoba.

162 In *A.G. Manitoba* v. *A.G. Canada (Manitoba Securities)* [1929] AC 260, the Privy Council held that the Act was *ultra vires* the Manitoba legislature insofar as it purported to prohibit federally incorporated companies from selling their shares within Manitoba without provincial consent, since it thereby interfered with the status and capacity of federally incorporated companies.

163 See Williamson, *supra* note 152, at pp. 12-13.

164 *Ibid.*, at pp. 20-1.

165 SO 1928, c.34.

166 SO 1928, c.33.

167 Williamson, *supra* note 152, at pp. 21-4.

168 *Companies Act*, SC 1917, c.25.

169 *Companies Act*, SC 1934, c.33.

170 Williamson, *supra* note 152, at p. 18.

171 *Companies Act*, SC 1935, c.55.

172 *The Securities Act*, SO 1931, c.48, empowered the Lieutenant-Governor in Council to appoint by regulation a commission or board to administer the Act.

173 SO 1945, c.22.

174 Neufeld, *supra* note 51, at p. 537.

175 Williamson, *supra* note 152, at pp. 266-7. See also V.P. Alboini, *Securities Law and Practices*, 1 (1984), at pp. 9-1 to 2; and Johnston, *supra* note 152, at pp. 388-9.

176 *Ibid.*

177 *Ibid.*

178 See the *Canada Grain Act*, RSC 1970, c.G-16, and the *Grain Futures Act*, RSC 1970, c.G-17.

179 Johnston, *supra* note 152, at p.15.

180 SO 1966, c.142.

181 SO 1978, c.47.

182 See the Porter Commission Report, *supra* note 49, at p. 348.

183 SC 1974-75, c.33.

184 See P. Anisman ed., *supra* note 12.

185 Neufeld, supra note 51, at pp. 381-4; Porter Commission Report, at p. 155.

186 C.S. Axworthy (1981) 'Credit unions in Canada: the dilemma of success', 31 *University of Toronto Law Journal* 72, at pp. 72-3.

187 Neufeld, *supra* note 51, at pp. 381-4.

188 *Ibid.*

189 SQ 1906, c.33.

190 Axworthy, *supra* note 186, at pp. 74-5.

191 SO 1922, c.64.

192 SO 1922, c.64, s.5.

193 SO 1940, c.7.

194 SO 1976, c.62.

195 RSO 1980, c. 102, s.11(1).

196 SO 1976, c.62, s.96.

197 RSO 1980, c.102, s.108, as amended by SO 1983, c.46, s.12.

198 RSO 1980, c.102, s.12, as amended by SO 1983, c.46, s.1(1).

199 Neufeld, *supra* note 51, at pp. 387-8.

200 Porter Commission Report, *supra* note 49, at pp. 159-60.

201 Neufeld, *supra* note 51, at p. 385-86.

202 SC 1952-53, c.28.

203 Neufeld, *supra* note 51, at p. 385.

204 Porter Commission Report, *supra* note 106, at p. 167.

205 See SC 1973, c.37, s.41, adding Part V (ss.87-91) to the Act, and as amended by SC 1983-84, c.31, s.14.

206 *Ibid.*

207 SC 1980-81-82-83, c.40, Part IV, s.57.

208 See J.P. Williamson, 'Canadian Financial Institutions', in P. Anisman, ed. *supra* note 12, at pp. 734-9.

209 Green Paper, *supra* note 106, at p.58.

210 Neufeld, *supra* note 51, at pp. 384-5.

211 (1967) 61 DLR (2d) 118.

212 *Ibid.*, at pp. 145-6.

213 In saying this we do not of course overlook the potential (and, to some extent, actual) conflict with provincial securities legislation involving securities' activities of banks. See William D. Moull, 'Constitutional aspects of bank regulation – silence on the Green Line' (1985), 10 *Canadian Business Law Journal* 71. However, so long as the existing Bank Act retains its restrictions on active bank involvement in the securities market the conflict is likely to remain unimportant. If and when the restrictions are lifted the potential for conflict will become much more acute.

214 We ignore the impact of the federal *Foreign Investment Review Act*, SC 1974, 21-22 Eliz. II, c.41, because the Mulroney government has committed itself to repealing the Act and replacing it with a much more modest one. In any event, FIRA applies to all foreign investments in Canada and does not single out financial institutions for special attention.

215 Ontario (1984) Interim Report of the Ontario Task Force on Financial Institutions. Table, p.7.

216 See Green Paper, *supra* note 106, p.58, Table 1.

217 *Supra* note 106.

218 See *supra* note 137.

219 Both the Ontario Task Force Interim Report and the federal Green Paper evince a sensitivity to the complexity of constitutional issues. The Task Force laments that interjurisdictional differences appear to be widening rather than narrowing and urges an immediate meeting of federal and provincial ministers to determine a process for harmonization. The federal Green Paper, based on the experience of the CDIC, voices confidence that harmonization will follow from consultation. Having stated the

ideal, both reports go on to make substantive recommendations relating to institutional design (which preserve or enchance parochial jurisdictions) and not towards achieving the goal of harmonization.

220 See *supra* note 11, at p. 49.

221 For the details of these jurisdictional conflicts and the co-operative federal and provincial legislation adopted to overcome them, see John L. Howard, 'Securities regulation: structure and process' in Anisman ed., *supra* note 12, pp. 1688-9.

222 Hogg, *supra* note 3, pp. 223-5.

223 Hogg, *supra* note 3, pp. 226-6.

224 For the details of the proposal and comments, see *OSC Bulletin* (1967) 61; J.A. Langford and D.L. Johnston, 'The case for a National Securities Commission' [1968] *The Commerce Journal* 21; Howard, *supra* note 222, at pp. 1690-2.

225 See W.E. Paterson, H.H. Ednie, and H.A.J. Ford, *Australian Company Law*, 2, 3rd ed. (Sydney, Australia: Butterworths) p. viii. The agreement itself is reproduced in volume 1, at pp. 6522 *et seq*.

226 The legislation is reproduced in *ibid*., and also in part in *Butterworths' Companies Act 1981: Regulations and Related Legislation* (1982 ed.) (Sydney, Australia: Butterworths).

227 For example, the empowerment of the CDIC to make emergency liquidity loans to provincially regulated credit union centrals.

228 Recent US experience is illustrative. In spite of a welter of congressional hearings and financial deregulation and reregulation bills in the last five years, little legislative action has been taken. Last September, the Bush Task Group (named after the Vice-President, who served as its chairman), whose membership included the heads of eleven federal agencies that regulate financial institutions, unanimously proposed more than four dozen specific recommendations for legislation to improve the existing system. Their report addressed which agency should oversee particular types of transactions, rather than how such transactions should be regulated. To date, no draft legislation has been introduced by the administration, and, with the passage of time, the prospect of near-term implementation recedes. See Task Group on Regulation of Financial Services

(1984) *Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services* (Washington, DC: The Group).

229 See, for example, Bruce Owen and Ronald Braeutigam (1978) *The Regulation Game: Strategic Use of the Administrative Process* (Cambridge, Mass.: Ballinger).

230 This approach is reflected in the Interim Report of the Ontario Task Force which, in response to the proclamation of Bill 75 in Quebec (allowing a substantial expansion in the activities open to Quebec-based insurance companies), proposes a 120-day notice requirement for any insurance company wishing to pursue activities beyond those allowed by the Ontario *Insurance Act*.

231 Canadian Committee on Mutual Funds and Investment Contracts (1969) *Report* (Ottawa: Queen's Printer).

232 The Montreal, Toronto, Alberta, and Vancouver stock exchanges, the Investment Dealers Association of Canada, and the Investments Funds Institute of Canada.

233 See, for example, Bill C-37, the *Canadian Commercial Bank Financial Assistance Act*, passed by the House of Commons on 29 March 1985, which authorized the federal minister of state (Finance) to enter into agreements with the province of Alberta and the banking sector to avoid the failure of the bank.

234 The Investment Dealers Association of Canada is statutorily recognized by a number of provincial securities administrators.

235 Section 15B(b)(2) of the *Securities Exchange Act* of 1934.

236 Subject to SEC approval.

237 This is the approach taken in the *Public Securities Act* of 1985, introduced on 15 April 1985 by Congressman John Dingell in the US House of Representatives. See HR 2032, 99th Cong., 1st Sess. (1985).

238 Reported in the *Wall Street Journal*, 12 April 1985, p.17.

239 The creation of a self-regulatory body for the investment industry was announced by the British government earlier this year. Following the lead of the insurance industry, several major banks have also recently agreed to appoint a consumer ombudsman (*The Sunday Star*, 12 May 1985, p. B4).

240 See R.C. Clark, 'The regulation of financial holding companies', 92 *Harvard Law Review* 789 (1979). In the United States the *Bank Holding Company Act* has imposed restrictions on transactions among holding companies and their affiliates since

1935. But the emergence of 'non-bank banks' that avoid the *Bank Holding Company Act*'s definition of a bank and consequently are not subject to the Act's restrictions pose similar concerns in that jurisdiction.

241 See, for example, concerns articulated by Grant Reuber, president of the Bank of Montreal, as reported in the *Globe and Mail*, Report on Business, 25 April 1984, p. 39.

242 FTC, Utility Corporations, S.Doc. No. 92, 70th Cong. 1st Sess. (1927-8). See also the Report on the Relation of Holding Companies to Operating Companies in Power and Gas Affecting Control, HR Rep. No. 827, 73rd Cong. 2 Sess. (6 vol. 1933-35).

243 49 Stat. 803.

244 See L. Loss (2d ed. 1961, Supp. 1969) *Securities Regulation* (Boston: Little, Brown) pp. 131-43.

245 See Porter Commission Report, *supra* note 49, at p. 372.

246 Which, in turn, led to the appointment of the Royal Commission on Corporate Concentration, which reported to the government in 1978. See Royal Commission on Corporate Concentration (1978) *Report* (Ottawa: Queen's Printer).

Comments

John Howard

I found this paper long, clear, and stimulating, but unfortunately generally right, which makes it rather awkward for me to comment on it. I will reserve some comments on the authors' organizational ideas, but that is relatively easy – I'm sure we all have some ideas there. The authors are right in the sense that they reflect more or less a consensus of most disinterested observers. Above all I agree with them when they subordinate legal to social and economic issues and, as Jacques Parizeau stated, look at the system from the point of view of the user and how the system can effectively deliver services to the user.

Just what the consensus is I hesitate to mention. But as I read it in the paper and indeed out of all the papers currently being published, the first is that you cannot confine these various financial or intermediary functions in organizational institutions. Therefore, mixed firms are inevitable. They will develop here or abroad, certainly outside the control of any level of government in Canada. As a result we are going to require some form of functional as distinct from structural regulation. The second thing is that the federal-provincial allocation of regulatory powers is at best anachronistic, at worst downright irrational. In his brief historical résumé, Mr Neufeld pointed out that the feds wanted banking in order to control the printing presses. They knew that was the key to monetary policy at that time, and they are determined now to keep it.

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The federal government has, I think, unilateral power to deal with most of these issues, not so much because of legal niceties, but because of its control over banking. It could create institutions, turn them loose, and, through unilaterally controlled federal institutions dominate the intermediary business. I don't think they would do it – I certainly wouldn't recommend it – but it does give Ottawa a fairly good bargaining chip in the negotiations with the provinces. As Ed Waitzer said, the feds will not and certainly should not try to exercise power that way.

I said that I would try to articulate the federal view. First, although I am from the West, I am an unregenerate federalist. Federal institutions are far more important than constitutional platitudes or generalities. I think that was the secret developed in the United States, with its various commissions. The commissions were not that good, but they welded together a very diverse, heterogeneous system into a powerful federal state. That is not because of extreme centralization, but because people began to identify big things in the country with federal institutions.

Second, reiterating what everybody who spoke today has said, competition and service to users should always be the driving force. Certainly we do not want a system that is bank-driven, as in West Germany. We do not want one that is state-driven, as in France and in part of Canada. Within the last few days we have closed (I hope) a small financing for a plant in western Ontario. One of the conditions our directors imposed on us was getting a million-dollar low-interest loan, or a no-interest loan, or a grant from the provincial government. To meet that condition took a year of negotiations. We did get the $1 million no-interest loan, but in the mean time we lost $1.2 million operating a plant because of the obsolete equipment in it. That is why you do not want the state involved in these things – it simply takes too long to make decisions.

The system should be user-driven. People here have asked: why all this regulation? Probably because of my corporation securities background I am still biased in characterizing securities as sensitive goods. Even today, with the many years I have put in dealing with these issues from both the government-law-office and the corporation point of view, I still tend to buy securities or other financial services on faith. I rely almost blindly on the person offering the services, and I think that is true of most people. If that is so, securities are indeed

sensitive goods, and securities dealings will therefore always require substantial regulation. However, I think we know enough now to be able to regulate smart and not try to confine the day-to-day decisions of people actually operating the business. Obviously, we want to stop the crooks; we want to build in adjustment systems that will render the failures less painful to individuals but that will work effectively.

I think, for example, of the discussion on the CDIC. If somebody sets up a rating agency – and the private sector will if government does not – to determine the insurance rates payable by institutions, you do not have to have a whole string of failures to develop rating criteria. And if application of those criteria forces some institutions to pay punitively high insurance rates, that will either confine their practices or will drive them out of business, and that is exactly what happens to other institutions and should happen to the financial institutions.

Something like conflict of interest we could regulate in great detail. But I think most of us know that it is not necessary to do that; to regulate in detail is to create safe havens. You just make it absolutely clear that people in these functions are always acting in a fiduciary capacity. You can create effective remedies for any breach of fiduciary duty that will cause all of them to stop, think, and take great care in making decisions where any conflict of interest or of duty exists, whether within an institution or among institutions. Corporate directors are sensitive indeed about these areas, and so are their counsel.

Finally, I share a little bit the bias of Jim Baillie, and that is to stop the analysis, stop the talking, and do something.

I advocated while I was in government that the federal government, if it is so uncertain about its power, should stop the endless debate, put together a statement of what it thinks its powers are, what objectives it wants to achieve, and how it wants to achieve them, and apply under section 55 of the Supreme Court Act by way of a reference to the Supreme Court of Canada finally to determine the issue. If it loses before the Supreme Court, then it knows that it has to try to negotiate some change in the constitution. If it wins then it is in a stronger position to sit down and discuss the issue with the provinces, which I concede it will have to do anyway. I don't think that any major program of this type will ever be handled unilaterally, not by this government nor by any other government.

Why a more flexible regulatory system? I think we have to look at the structural changes in the financial intermediaries themselves and what the view is from the corporate treasurer's office. He or she is looking around for funds, hedging on international investments, hedging against various sales made in major jurisdictions, looking at the various instruments available, and above all else, evaluating the real cost of capital. He or she does not care if it is characterized as a conventional share or debenture, a banker's acceptance, a money-market instrument, a letter of credit, or a back-up guarantee. People go out and seek the lowest-cost source. The writers have used a very good phrase in their paper in talking about the financial markets as becoming part of the seamless web. I find that a very good image to describe what is going on, because no longer from the corporate perspective do you care very much where you get the money; you look above all at the cost of the money and the amount of regulatory friction involved in raising that money. If that is true, it means that the instruments also matter very little. At one time we were all taught that instruments fell into nice clear categories of common shares and preferred shares, debentures, and term bank lines. Now, in fact, it is becoming harder and harder to distinguish among term operating lines at a bank, bank term lines, debentures, debt, money-market instruments, and various other instruments. Shares – for example, preferred shares with a retractable put-back to the corporation – are not very different from a straight demand loan, and there has become such an overlap and intermingling of these concepts that they no longer mean much. As I say, the treasurer just wants to raise money; he doesn't give a damn how the lawyers characterize it, or how they get it through the administrative system – he just wants the cash.

Again, I emphasize developing a system that does not pander, that accommodates the practical needs of the treasurer who is obtaining that money. Obviously I have a business bias, but I include also the household consumer who wants services from these systems.

Developing computer communications utility services will almost certainly force this issue in this decade – certainly by the early 1990s. We will have networks of information systems that will make all monies flow much more easily, disregarding virtually all the institutional concepts we have known in the past.

I want to comment on the authors' discussion of the federal Green Paper, which they say might accentuate the regulatory imbroglio. There is no doubt that if it is forced in that way it will engender a great deal of conflict. Again you have a level of government – a regulatory agency – wanting to put its thumb on the scale. However, if that is the only way to force the issue, do it and deal with the conflict as it arises. I am not as skeptical as Jim Baillie, who thinks it might take ten years to force this debate. But I always remember the famous line: how do bureaucrats cut red tape? The answer, of course, is lengthwise. You always have to remember that. It is not altogether bad, because when things are done in government they must be seen to be done right. If they are not done right, that doesn't matter: the form counts more than being right. In the business sector you have to do it right at least half the time, or you are out of business altogether.

As I say, I'm not as skeptical as Mr Baillie, but I agree that it will take some time, which gets me to the proposed structural change and some of my ambivalent feelings about it. I like one feature of it. I have the feeling that if I were working in that system the bureaucrats would never catch up to me; by the time they ever got through that maze I would have done what I wanted to do and I would be dead before they identified any misconduct. As a result, partly because I dislike the complexity and partly because I am more autocratic, I would just wipe out all those layers and have one layer, that is, a federal-provincial commission of financial institutions, that would develop specialist panels to deal with various problems but that would have oversight of this market. As I say, it is a seamless web, and the conceptual legal distinctions among these various legal institutions are breaking down and becoming subject to generic legal and regulatory concepts.

However, I cannot see how the proposed system can ever work. It strikes me as really a bureaucractic cycle, and I think that somebody has to be accountable. Somewhere the buck has to stop and, in the event of an impasse between the commission and the council of ministers, I would give the federal cabinet tie-breaking power. I doubt that any issue would ever go that far, but it is a very practical constraint. The knowledge that it could go that far forces the various ministers to compromise and somehow solve the problem perceived by the industry and by the public.

My one major criticism of the paper is its conclusion that we should do some further analysis. Any more study, analysis, and reports on this financial industry, and I would just give up. Interested as I am in it, I have a feeling that we are now overwhelming practical people with paper. The time has come to stop and do something; even if we do it wrongly, we can adjust, correct, and redo it.

In conclusion, I think your paper covers all the constitutional issues very well. My basic criticism is that it would lead to a real paralysis, both if we had more analysis, and also if we have the proposed structure. If the structure has to be that complicated to accommodate all the actors in it, we should just allow chaos to develop, learn how to work with that chaos, and intervene on an incremental or exceptions basis to regulate and stop overt misconduct. As I have stated, I think we can 'regulate smart.' Ideally – because of my nature – I would like to regulate proactively, to try to set up a simplified system that would obviate a lot of the fine-tuning that is going on now because of conflicts among various sub-systems. But if that is not possible, I can live with a lot of instability, a lot of chaos. I think most of us are accustomed to that in Canada. Even if we have to take on more risk, I think that is a better way to do it.

In summary, I would like to say that, except for that stricture, your paper is a great contribution to the debate.

PART III: PROVINCIAL PERSPECTIVES

The challenge of dynamism

W.T. Pidruchney

INTRODUCTION

'The more things change the more they stay the same.' This is a phrase we should consider in discussing the changing regulatory environment for Canadian financial institutions. It has already been said that we have a very efficient capital-raising system in place in Canada, and Jim Baillie made a point this morning when he said that we should probably consider taking steps incrementally as opposed to overturning whole systems and replacing them with new but untested ones. In other words, let's not throw out the baby with the bath water.

PROVINCIAL ASPIRATIONS

I believe it is legitimate for a province to aspire to economic and financial self-sufficiency and self-determination. I don't think anybody will argue very strenuously against that position. The strongest economy and the strongest economic federal union occur when all the component parts of the union are strong. If the provinces and territories are economically strong, then the federal system will benefit.

The attainment of these aspirations of economic self-determination depends on the success of local business in trade, commerce, and industry. Pierre Lortie, in a paper he delivered to the National Economic Conference in March 1985, said that the most employment is created by new firms forming and by fast-growing small and medium-sized firms. Creating employment is one of the economic targets of the whole country and should be nourished.

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A healthy capital market is fundamental to the success of local business. Mr Lortie observed that there is no substitute for a sound equity base for small business. I agree with him. He also makes the point that the major source of equity for small and medium-sized firms is individuals. Institutional investment in small firms does not occur, and if it were compelled to occur it could only be done artificially, with the chance that it might cause distortion in the marketplace.

In Alberta our aims are the enlargement of our agricultural and resource-based economy to include an industrial and manufacturing base, development of the province as a financial centre to serve our provincial financial needs, and the maintenance of a free-enterprise capitalistic financial and economic system. You are all aware that our province put out a White Paper last July. There was a lot of criticism from the private sector directed at those portions of the paper that suggested that the government should play a larger role in encouraging business and industry, notwithstanding the fact that the intentions were to assist the private sector.

A PROVINCIAL REGULATOR'S PERSPECTIVE

Protection of investors

The discussion this morning and Jacques Parizeau this afternoon focused on the purpose, aims, and objectives of the financial sector. In the securities industry, it is the investor we want to protect. It is my view that regulation should not intrude into the normal operation of the market system.

Mr Baillie has indicated, and I think a lot of us agree with him, that regulators cannot fix everything. I would like to point to another regulated area as a very good example. I am speaking of regulation of betting at the race tracks. No bettor who has lost two dollars at the race track telephones the Solicitor General or the Attorney General or Consumer and Corporate Affairs asking for indemnification or insurance or reimbursement for his two dollars. Yet he or she was participating in a high-risk gambling enterprise. The reason they don't call is because they go to the track knowing the rules of the sport. They are at the track and know the odds because the odds are disclosed on the tote board. They know that the racing is operated honestly.

If the securities regulators – and perhaps financial regulators – can deliver that to the public, it probably would serve the ultimate purpose of investor protection. I query whether it is a legitimate aim of a securities regulator to ensure the efficient operation of the capital markets. Certainly, a regulator must be cautious about intruding into the business sector.

An effective national system

I suggest that the existing system of national regulation by provinces is effective. First, all the provincial regulators come together as the Canadian Securities Administrators to form a national network of regulators. Although Ontario and Quebec dominate in the financial sector, particularly in securities, all the provinces operate on a consultative basis. These two leading provinces are the first ones to ensure that consultation is done with even the smallest provinces, so that changes encompass interests and considerations across the country.

Second, the Canadian securities administrators have a commitment to compatibility of regulation where uniformity is not possible. Uniformity exists in several national policies and is occurring systemically in the formation of universal one-step electronic filing systems, which are now operational in Quebec and Ontario. There is more uniformity coming in legislation. British Columbia and Saskatchewan just introduced legislation; Nova Scotia's is in place. This legislation is based on the Ontario model, which is also the model for Alberta and Manitoba. Two weeks ago, at a meeting in Toronto, the Canadian administrators formed a 'uniformity committee'. The four provinces forming the committee have undertaken specific projects to focus on uniformity and bring it into being as quickly as possible. This includes systemic uniformity in terms of electronic one-step filings and so forth, as well as policy and legislative uniformity.

Provincial regulation preferable

Provincial regulation of securities may be preferable to federal regulation, and I believe that it is absolutely necessary if a province is going to fulfil its own economic objectives. A province is far more sensitive to its local needs, and it generally has more incentive to achieve its economic objectives. Its size allows a faster reaction time to get its legislative changes in place. It can set its own agenda and

also control its own timetable. These goals are problematic in the hands of the federal government.

The present provincial regulatory system accommodates the Canadian equity capital-raising market system, which is one of the most efficient in the world. In 1984, governments raised $25 billion while business raised $11 billion. The Canadian investment system raises more capital through the securities market on a per capita basis than any country in the world. If the system works, why should we be 'fixing' it?

The diversity that comes by virtue of using provincial systems reflects the reality of diversity of this country. The present provincial system allows a freedom of choice and flexibility in a province's pursuit of its economic and financial aims. We have a very live example before us. About three or four years ago, the province of Quebec put into place a Quebec stock savings plan (QSSP). I believe the plan, or something like it, had earlier existed in France. The Quebec plan has provided an abundance – or an embarrassment – of riches, and the interesting thing was that it was done virtually on an experimental basis. Here is an actual live example of a jurisdiction that was not going to wait around for the rest of the world. It went ahead and did something that worked.

Recently in the *Globe and Mail*, the lead story said that Ottawa may follow the example of the QSSP. The premier of Alberta has indicated that we will probably put one in place in Alberta by the fall if it is not done on a federal basis. That is another of the beauties of our diverse provincial system: you can run a test-tube case, or clinical case, on a local basis to determine how it is going to turn out. If you deal on a federal basis, and if the system or the experiment turns out badly, the whole system may collapse. The present system allows different jurisdictions to experiment with different concepts, and if they are successful, they can be expanded nationally.

The institution of a federal regulatory system would bring a substantial new cost to the federal budget and would create another layer of regulatory bureaucracy. The Green Paper suggested that its proposals would create three more bureaucratic bodies if implemented. All those things have their own cost.

The direction of regulation suggested in the Green Paper is one thing that I do agree with, namely, that regulation of the financial industry be on an integrated basis. Alberta's minister of Consumer

and Corporate Affairs has announced in the legislature that the institution of an integrated financial services regulatory commission for the province will be looked at very shortly. The study will consider all those agencies of a provincial nature that deal with financial services, including real estate, insurance, investment contracts, trust and loan companies, as well as the securities commission.

Dealer/broker exclusivity

I believe that we should seek to maintain and even enhance the exclusivity of the investment dealer/broker in the securities industry. This is not a protectionist position, because I am just a bureaucratic regulator and I don't have any position to sell to you. It is based on my view of reality and common sense. Industry has indicated that it is doing an efficient job. Why cripple it by bringing in competition where we have such a great degree of concentration? There are other reasons as well: 'stocks are sold and not bought,' as the axiom goes, and the raising of equity capital requires an aggressive pro-active sales system. That is exactly what our investment community in Canada has in place now, a highly sophisticated and effective sales network. Other financial institutions do not need to enter the securities market for reasons of subsistence or survival. My figures indicate that banks and trust companies have managed quite profitably, in large measure, without selling securities. To them, it could easily be a sideline, and the day that we treat something as important as raising equity capital as a sideline we are in trouble.

An active sales force is required to bring first-time investors into the market. That is critical to a provincial economy, and it is very difficult to do. The average Albertan investor puts $6,000 in the market each year. Vencap Equities Limited went to the market in Alberta approximately a year ago to raise equity capital. Application was made to our commission to allow the Treasury Branch and credit unions to sell shares, on the assumption that investment dealers could not appropriately or adequately sell to Albertans first, as was the policy. It was argued that only the network of banks and treasury branches could access Albertans in the hinterland. Our commission denied that application. We said that banks, treasury branches, and credit unions should not be brokers. The Vencap issue was oversold dramatically by the investment industry alone, which speaks very well for the investment industry.

Investment dealers and brokers operate in a sophisticated and specialized area. This is consistent with the age of specialization in which we live today. Despite all the talk about conglomeration, everybody in every business is tending to specialize. Yet in this particular area, for some reason, we want to make institutions generalists. This is contrary to the direction society is going.

The investment industry has two protections built into it on behalf of investors. First, any salesman or dealer is obliged to know his client. Second, to protect investors there is a national contingency fund of some magnitude, which is continually being improved. Financial institutions that might purport to be in the securities industry do not provide such protection. They have no national contingency fund, no insurance, no deposit insurance for investment funds, and no trained securities people.

Raising small amounts of equity capital

Notwithstanding my earlier comments, the investment industry is not perfect. There is a gap in the equity-raising market for issues of less then $5 million. Investment dealers are reluctant to service the small dollar needs of small issuers, most of which are junior or local companies. This reluctance probably is linked to lower profitability. Governments have involved themselves in programs to cover this gap (e.g., QSSP, Vencap, SBEC). However, is preferable that the industry and not government meet this market need. The small retail investor is the most likely source of equity capital for a small local issuer.

The investment industry could meet this gap in two ways. First, head offices of national investment firms could become more sensitive to local needs by developing regional service policies, making resources available to underwrite or to take small issuers to market. Second, the industry could form a consortium of the investment firms serving a province for the purpose of having the consortium underwrite and market small issues. Large issuers can gain access to capital markets on a national and international basis as required.

The stock exchanges

The exchanges operate as competitive businesses that are self-regulatory under the jurisdiction of securities regulators. It is likely that exchanges of international stature will rationalize and become

fewer in number. As a result, regional exchanges will be compelled to become specialty exchanges. For example, the Alberta Stock Exchange views itself as being a start-up exchange for small companies, particularly for resource and industrial companies.

Institutionalization of markets

The institutionalization of the markets has changed the nature of the market. Whither the retail investor? Because of institutionalization, there is less emphasis on the retail investor. There is a growing concern about precipitous moves by large shareholders and about the impact of institutional shareholders on corporate management.

THE NEED FOR SEPARATE STRUCTURE, FUNCTION, AND LIABILITY

I want to commence by blowing apart the 'four-pillar' analogy with which I have always been uncomfortable from the day I heard it. Those pillars are so uneven, so different in height, so different in girth, that it is no wonder we do not have a 'level playing field' if it is those pillars that support it. The relative financial sizes in the structure – of the banking system, trust companies system, securities system – are so different that those pillars cannot all be the same height. Accordingly, I think it much better to use the playpen analogy and say that everybody is on a level field but they all have different-sized playpens.

Bankers and other financial intermediaries should not be investment dealers or brokers. Ownership (in whole or in part) of an investment dealer/broker by a financial institution may be acceptable, provided there is complete separation of structure, function, and liability.

There is an inherent conflict in a financial intermediary also acting as a market intermediary. Investor confusion is enlarged. Unsophisticated investors still have problems distinguishing between deposits and risk investment, especially when dealing with a conglomerate-type of institution that conducts several functions. The brokerage function is a core function to an investment dealer/broker.

Provincial interests dictate that local investors be encouraged to come into the market. This requires the pro-active marketing approach of the investment industry. Financial intermediaries are traditionally passive marketers. Decimation of the investment

dealer/broker industry by loss of exclusivity may cripple the ability to raise equity capital. In addition, the regulatory burdens and costs are compounded as more institutions enter the field.

SUMMARY OF OTHER MATTERS RELATING TO THE FINANCIAL INDUSTRY

Regulatory objectives should be the prevention of problems for the consumer and the provision of valid remedies for the consumer. Investigatory, enforcement, and punitive functions of a regulator are of little consequence to a consumer who has sustained a loss.

The consumer's interest is best served when he or she (1) is educated in the field of financial services and investment, (2) is able to receive objective, independent advice in his or her best interest, (3) has confidence in the operation of the marketplace, and (4) has valid remedies available when problems occur.

The development of financial advising and planning services accessible to the retail consumer is an important new direction in financial services. Ideally, the adviser/planner should be independent (remunerated in whole by fee for service), objective (not affiliated with any financial or marketing institution), and knowledgeable in the art. Conglomeration of services will give rise to cluttering and confusion, and if it gives more choices of institutions and products it will also give rise to more difficulty in making choices and more need for independent objective advice.

The consumer's interest in cases of improper loss is in recourse for monetary compensation rather than in the punishment of a wrongdoer. Recourse for compensation should ideally be built into and administered by the industry. External agencies for recourse must be streamlined or new ones established. Specialized courts dealing in financial matters may be in order. The right to class actions by depositors and investors should be developed, and regulatory agencies might be empowered to order damages or civil remedies.

Industry self-regulation is not only the most desirable form of regulation (subject to supervision by a regulatory agency), but can be more effective, efficient, and less costly to the taxpayer. Government regulation of financial institutions and/or functions would be more effective and efficient if it were integrated regulation.

The first steps of a deregulator

Jacques Parizeau

As we will be spending two days discussing deregulation of financial institutions in all its technical aspects, it would be rather futile on my part to try to cover a wide spectrum of principles and modalities of deregulation in the few minutes that I have at my disposal. As I have been rather involved in the process over the last two years, I will simply attempt to underline some of the broader issues that as a deregulator I have had to deal with, and that I feel must be handled. These issues are often rather simple. The ways and the means may be awfully complex. Yet in devising them, we should not lose sight of what we are trying to do.

First, it is frequent to hear that technological change, diversification of financial transactions, and multiplication of financial vehicles have brought about considerable pressures to lower or eliminate altogether the barriers between the so-called four pillars of financial activity. I do not, for one moment, want to minimize the impact of such developments. Yet another development has, to my mind, a more fundamental importance. It has to do with the way the customer is served in the present system. One cannot imagine that market forces are likely to supply the customer with what he wants. All financial institutions are so heavily regulated that competition and changes in ways to satisfy customer needs must be translated into legislation and regulation before they can be fully operational.

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It seems, in that regard, that our legislative framework has been based on the unwritten principle that the service requirements of customers were, for most of them at any rate, fairly simple and unsophisticated, while for a very small proportion that have complex requirements, means were available to have access to sophisticated counsel and expertise.

For a long time, this description seems to have been a realistic assessment. For most people, savings were in practice concentrated in a house, a life insurance policy, and a pension fund. Other needs, like property insurance, an occasional loan to finance a car, and a deposit and chequing account somewhere, were easily understood and easily supplied.

This has changed profoundly if gradually. Forty years of increasing prosperity have dramatically multiplied the number of people who are involved in diversified financial operations without having necessarily the technical means to handle them properly. Governments have multiplied to such an extent the number of fiscal shelters and types of fiscal expenditures that most people, even among those who can use them, have no general overview of what is available. It is a remarkable phenomenon of modern taxation that it takes several years before a new tax shelter is broadly used by those who have an obvious advantage to partake in it. Furthermore, financial institutions, within the legislative constraints applicable to them, have diversified the vehicles by which they could reach a rapidly growing clientele.

And finally, the huge rise in interest rates starting in 1979 has intensified the impact of all three preceding factors. Suddenly, the rules of the money game were so profoundly changed that those customers who had kept conservative and stable practices were thrown in a whirlpool. By the time short-term interest rates reached 20 per cent, people were shifting money from vehicle to vehicle, from one financial institution to another, shopping around as never before or reacting to representations made to them by all kinds of agents.

It is all very well to suggest that the average customer is unsophisticated and does not invest his money as well as he could. Let us recognize that the system that was set up to serve him, once ideally suited to his needs, now falls short of being transparent enough.

Does this imply that we should strive to set up what have been called financial supermarkets – in other words, establishments where

customers could find just about all the financial services that they require, and the type of diversified advice that is not fully available today? As far as I am concerned, this would seem a reasonable objective.

Yet such a proposal would not seem to be enough in improving services to customers. There still exists an awful lot of personalized services and sales conducted by individual agents and brokers. Many people purchase financial vehicles from individuals. Agents or brokers are usually limited by the permits issued by the regulatory authority to deal in one type of transaction only. One cannot imagine easily that the powers of financial institutions would be extended and diversified, while the agents they employ would remain rigidly specialized. Thus appears a problem of multipermits which would provoke a major upheaval at the retail end of operations. It seems that in recent discussions about deregulation, not enough attention has been paid to this aspect of the question.

Another issue I would like to raise has to do with competition among financial sectors and among firms. The degree of concentration of the Canadian financial sectors is remarkable. This is true in each of the subsectors except property and casualty insurance. Such a high degree of concentration has helped some of the major Canadian financial corporations to gain a stature in world markets that they could not have achieved without the broad domestic base that they had conquered.

Public authorities have helped this development. The gradual but systematic widening of powers given to the chartered banks over the last thirty years has been a powerful help in building the largest banks into major world market institutions. However, governments refused just as systematically to widen the powers of other financial institutions. The results were startling. While twenty years ago total assets of life insurance companies were about equal to those of chartered banks, today they represent less than those of the largest Canadian chartered bank.

There has been some unease about the degree of concentration in the banking industry for some time, but the same can be said about concentration in other financial sectors, even if individually they are not as large.

How should we go about increasing the degree of competition? There are three ways to do it. And in fact, there are only three ways.

The first is to help the setting up of brand-new domestic firms starting from grass roots. Considering the cost of entry to be at the outset a significant factor on the retail market, this road is a difficult one, as we all know after some Western Canadian experiences in banking. The second way is to open unlimited access to the Canadian market to foreign interests. This has never really been accepted in Canada (except historically with respect to general insurance). Schedule B banks can, and do, make an inroad into the wholesale market, but they are not and cannot be a factor in retail operations. Yet, possibly, one could imagine that foreign interests could be used to increase the degree of competition, but it does not seem to be in the cards for the foreseeable future.

The third way is to widen the powers of raising funds and investing them for all financial industries in Canada and thus allow their activities to overlap. Thus competition would be opened between giants, and therefore would be real. Furthermore, competition would thus be opened between institutions that already have large retail organizations.

Yet outside the circle of the major banks, the relative size of existing corporations has slipped, as we have mentioned previously. Thus, mergers or acquisitions over a wide range should be allowed. Furthermore, we should correct a bizarre situation that has arisen from the vagaries of Canadian tax laws. For years, life insurance companies could escape all taxation on their profits if they were mutualized. Several of the larger ones thus became mutuals. Now, of course, the tax laws have been changed. But the mutual companies remain strapped with their own funds. Their expansion in other fields of activity will require access to capital that, at the present time, is not available to them, if that expansion is to be at all appreciable in terms of global competition. It is in that context that downstream holdings were set up in Quebec. Obviously, this simple-minded idea has had peculiar repercussions at the senior level of government, but more of this later.

This example of the downstream holding is interesting, however, as it points out the direction that increased competition can take. The general idea is that the number of players in all financial fields might be reduced overall, but that through deregulation, all the remaining players will truly play against each other rather than in separate leagues.

Does that mean the death of the small entrepreneur? In a sense, no more and no less than in nonregulated industries. There will still be room for the small, highly specialized organization. And the multipurpose small firm will still risk falling prey to acquisition attempts on the part of the majors. What else is new?

The third issue that should be raised has to do with the very expression of deregulation. This is a bastard term, the fact of bringing down the barriers between the pillars being seen as a way to reduce the degree of surveillance and to blunt the instruments by which it is carried out. Nothing could be as foreign to public interest as that sort of attitude.

In fact, recent crises that the federal, Ontario, and Quebec governments have had to go through have shown that something is very rotten in the kingdom of financial surveillance. It is amazing, in a sense, that in a matter of a few years, chartered banks should have so overexposed themselves to all kinds of exotic loans abroad or to some enormous domestic loans of high risk. It is extraordinary that in Quebec a co-operative movement that had more than 300,000 members should have been allowed for so long to suffer financial policies that, in due time, produced the largest bankruptcy that Quebec ever witnessed. And the story of the trust musketeers of Ontario is a textbook example of what should not happen.

Our noses are bloody, and for good reason. Taxes are levied on Canadians – and by both levels of government – to pay for the costly lessons of not observing century-old elementary principles: that one should not borrow short to lend long, that self-dealing can be self-defeating, that different levels of risks should be translated into different rates of interest.

That such difficulties should not be used as an argument against deregulation (understood as the overlapping of financial activities among the financial institutions) is beyond me. The problems arose while the pillars were still well separated. The laws ruling each of the sectors were considered the very expression of prudence. Warning signals had been numerous. What in fact happened was that some of the sentries were asleep while others had no rifles.

In a sense, what has occurred is useful. Deregulation should not take place unless powers of surveillance are considerably enhanced, resources are made available in sufficient quantity to regulatory

boards, and unless, in everyday life, these regulatory boards not only can be but are ferocious in their interventions.

Such developments imply rather precise changes in our ways of doing things. For instance, while banking legislation has traditionally given considerable importance to liquidity, in the case of other financial institutions profitability and medium- or long-term risks have been the real yardsticks. Thus, such institutions came to be far too sensitive to mismatching. A lot of the problems of deposit insurance are still due to the fact that liquidity ratios have not yet been understood by the legislator for what they should be. The result of this is inevitable: deposit insurance is relied upon much more than is reasonable and becomes the guarantor of irresponsibility on the part of the regulated and the regulator.

Furthermore, we must accept more readily a degree of discretionary power on the part of the regulatory authorities, exercised independently from ministerial authority. At the present time, it is too often the case that discretionary authority is exercised to circumvent legal obligations under pressures either from political lords and masters or simply from public opinion. The holders of regulatory authority are often seen among the industry as ignoramuses if not nitwits until such time as, forty-eight hours before a run on the cash box or before bankruptcy, they become the saviours of capitalist values. These chaps must be supported and protected. I would much rather have them withdraw a permit, impose a merger, or force a liquidation, than have them come running at the last minute trying to prevent a bankruptcy at the taxpayer's expense.

What has been done in Quebec over the last few years has reflected that preoccupation. A very simple deal was proposed to financial corporations. Their powers of investment, of gathering funds, and of operating in other fields than their original one would be considerably broadened. But, at the same time, they would accept stringent controls exercised by the newly appointed inspector of financial institutions.

In other words, deregulation does not imply less regulation but more. Deregulation implies a wider spectrum of activities, but at the same time it implies an enhanced degree of surveillance based on profound changes to the relevant legislation. What is meant here is that legislation must recognize not only the companies but each of its

different activities, and bring each of these main activities under distinct provisions.

I do not imagine for one instant, however, that we are likely to find easy answers to some fundamental questions with respect to deregulation of financial activities. I cannot say, for instance, that I am satisfied with the solutions that have been proposed until now in Canada regarding conflicts of interest. While I recognize the usefulness of Chinese Wall provisions to protect the fiduciary functions of trust companies, something is still missing for possible conflicts of interest in the case of other transactions. In that respect, recent British provisions would seem to improve considerably on the thinking about such subjects by Canadians.

Yet, on the whole, it seems that, after the Green Paper of the federal government and various provincial initiatives, the main thrust of things to come is clear enough. And, as I tried to point out, I think it is all to the advantage both of the customer and of a proper degree of competition among financial institutions.

A great deal remains to be done – at the operational level, no doubt, but also with respect to the jockeying for position of the various governments involved. Federal-provincial and interprovincial relations will obviously bear considerable weight in the next few years, and, in closing, a few words about these relations would seem to be relevant.

It is understandable that Quebec should have moved first as far as deregulation was concerned. The indigenous financial sector is, on the whole, rather large in relation to the major banks and other national financial institutions. However, institutions that may be of some size as far as Quebec is concerned are fairly small when compared to Canadian organizations. A process of concentration and of diversification offered in advance of other jurisdictions can supply what may be lead time of strategic importance.

Obviously, the advantages of rapid deregulation in Quebec can draw some financial activity from elsewhere. No one will be surprised that such an assessment did not escape notice and that the government might also have taken it into account in its decision to move quickly. In the process, pressure was being applied upon the federal and the Ontario governments to do something or at least to give some indication of where they were going.

It was understandable also that the Ontario government, until it was ready to move, would, through its regulatory agencies, pressure

Quebec insurance companies that operated in Ontario not to use the powers that they derived from the new Bill 75, under the threat of losing their permits to operate in Ontario. That is par for the course, even though it really should require the Quebec government to adopt retaliatory measures. None of this is particularly useful for whatever goals we eventually pursue in the restructuring of the financial markets, nor is it conducive to better service to the consumer. But it is understandable.

The federal government, after years of practising the status quo with regard to everyone except the chartered banks, has finally decided to open up with, if not a White Paper, at least a green one. The broad objective of deregulation is clearly sketched. It is not my purpose here either to try to summarize or to analyse the Green Paper. I would simply wish to underline the fact that the proposed holdings that are such a crucial feature of the Green Paper seemed to be geared as much towards extending the scope of federal jurisdiction over the various financial institutions as to creating a vehicle to improve their capitalization and their expansion. There again, it is par for the course.

In other words, each government looks at deregulation with several purposes in mind. Negotiations will probably be difficult, as they often are in this country. Deals will be made, and in the end we might be faced with a perfect camel – in other words, a horse drawn up by a committee.

In the process, obviously a long one, it might be a good idea not to forget a basic principle with which I started this short intervention: improved services to customers and increased competition are the very basis on which the new system should be established.

Security and diversity in the financial services industry

Robert L. Andrew

Those of you who follow the news may know that over the past six months I have obtained some personal experience in the field of financial institutions. Pioneer Trust, a Regina-based company, found itself in an insolvent position last fall. Our government became involved in trying to see if it might be possible to keep it afloat, but eventually we came to the conclusion that the costs exceeded the benefits of doing so. Consequently, the company is in the process of being wound up, and our government, in conjunction with the federal government, has taken measures to assist the uninsured depositors.

If I learned anything from my experience, it is that, when it comes to the handling of financial institutions, there are no easy answers – there are just so many conflicting concerns we have to deal with. I know that sounds trite, but I think it is important to underline just how difficult and complex the questions are. This argues for caution in the implementation of new policies. It also argues for some skepticism toward those who would have us believe that financial utopia awaits if only we will follow their particular prescriptions.

I think it is also important to keep in mind that the particular prescriptions advanced often coincidentally dovetail with the interests of those proposing them. I do not claim that I am any different. The position I will advance today is, at least subconsciously, affected by who I am and what I represent. The present government in Saskatchewan is best described, I think, as being a Prairie populist one. What that means is a loosely defined philosophy that, among

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other things, thinks that ultimately 'the folks' are wiser than 'the experts', gives the benefit of the doubt to the little guy, and tends to be suspicious of big institutions in general and big eastern institutions in particular. I suppose it is inevitable that my perspective on financial institutions should, at least in small measure, be affected by that. So consider yourself warned.

Let me start the substantive part of my discussion by outlining what I think the basic objectives of regulatory reform of our financial institutions should be.

OBJECTIVES OF REGULATION

In its recent Green Paper on the regulation of financial institutions, the federal Department of Finance listed nine principles that it believes will better serve the public interest. In my opinion, only two are required:

1 Money put on deposit in financial institutions must be fully secure – not just up to some arbitrary limit. Having just gone through a situation involving 1,800 uninsured depositors, I am convinced that any notion that it is up to the depositors to be fully informed about the risks they take in putting money in a particular institution will not fly politically or morally.

2 We must maintain and enhance the diversity among our financial institutions, in size, function, specialization, and regional base. It is such diversity that will ensure that our financial institutions are competitive, innovative, and efficient.

By implication, I do not believe that a financial market dominated by a small number of large, essentially identical firms will achieve what we want. We need the small firms barking at the heels of the larger ones to keep them on their toes. We need the specialized firms serving small market niches. We need the regionally based firms that will have a particular knowledge of and a particular commitment to their regions.

I do not suggest that big is bad; but if that bigness precludes diversity, then yes, I do think it is bad.

Achieving these objectives

How might these two objectives be achieved? If we listen to what I will refer to as the 'big five's' viewpoint, it would seem that the two objectives are difficult to reconcile. By the 'big five' I mean, of course, the largest five chartered banks in this country. Their position might be summarized as follows:

1 Lending money is inherently a risky business. Businesses fail and people lose their jobs, making it difficult for the lender to realize on loans to those businesses or individuals.

2 In order for a financial institution to withstand this it must have a larger number of performing loans that more than make up for these losses.

3 The probability that the performing loans will outweigh the non-performing loans increases with the number of loans and the geographic dispersion of the loans. The latter is important because, for example, while the BC forest industry may be down at any point in time, the auto industry may be up, and vice versa.

4 Because of this basic notion of risk pooling, large national financial institutions (e.g., the big five) seem to be the vehicle to deliver a financial system that is stable and that provides the necessary security to depositors. After all, the big five will tell us, when was the last time a large chartered bank failed? While we may not like bigness, it does seem to provide stability.

So the big five's argument would seem to suggest that we must choose between security for depositors and diversity among financial institutions. If there are any representatives of the big five in the audience, I hope that you do not think I have been unfair. Let me be clear: I have no particular fight with the banks. But they have a particular position to advance, just as I do.

It seems to me that what I have called the big five's argument is flawed in two related items:

1 It assumes that all risk pooling must be internal to the firm.

2 It assumes that the security of deposits is synonymous with survival of the particular financial institution. I think this latter

assumption has been allowed to dominate our thinking about financial institutions for too long.

Neither assumption is valid if we admit the possibility of insurance. The very essence of insurance is a recognition that there are advantages to pooling risks with others. If deposits are fully insured, the link between their security and the survival of a particular firm is broken.

The objection to full deposit insurance, again led by the big five, is that it results in the prudent financial institutions' subsidizing the imprudent ones and provides the depositors with an incentive to search for the highest rate of return without regard to risk. As it is currently constituted, this is partly true – but keep in mind that deposits are insured only up to $60,000. It seems to me, however, that this situation doesn't argue against full insurance, but only against our present method of administering insurance. It should be possible to design an insurance scheme where the premiums that any particular financial institution pays are a function of its risk of failure. Bond rating agencies grade the credit-worthiness of financial and non-financial institutions. It seems to me that essentially the same analysis would be required in the context of deposit insurance premiums. If we could design such a system, the imprudently run institutions would pay a price. This would strengthen, not weaken, the soundness of the financial system. I suspect that most people would find this suggestion acceptable, at least in principle. The application of it, however, might be more troublesome than I suspect.

What is sure to be more controversial is a further proposal to differentiate the premium structure along another dimension – that of size. I would suggest that, holding the level of risk constant, smaller financial institutions should pay a lower premium rate. I propose this to compensate for the fact that, even if a small financial institution has a balance sheet with the same quality as that of a large financial institution, the market will judge the latter to be more credit-worthy. Larger institutions have an advantage in this context:

1 Their scope for risk pooling is larger.

2 The larger the financial institution, the greater the probability that the government will not let it fail.

Neither of these provides a real benefit from society's point of view, and we thus should not allow larger firms to be able to capitalize thereby. Remember, I think diversity is something worth maintaining and enhancing.

Let me summarize my arguments to this point. I do not believe that the domination of our financial markets by a handful of large, essentially similar financial institutions is necessary or desirable. The linchpin in a system that reflects this is a properly designed deposit insurance scheme.

THE FEDERAL GREEN PAPER

So far, I have not had much to say directly about the federal Green Paper. I suppose the least controversial parts of the paper are those dealing with regulation. I think we can all agree that an improvement in regulation is called for and that this will require co-operation between the federal and provincial governments.

The more controversial areas are those that deal with the structure of the financial system – the four pillars, holding companies, Schedule C banks, and so on. This whole question is an extremely tricky one. Should we try to preserve the four pillars? Could we preserve them if we wanted to? Should we allow concentrated ownership of financial institutions?

My concerns tend to centre around the proposal to allow financial holding companies to set up Schedule C banks. I fear that this would help further to consolidate the concentration of control of Canada's financial and non-financial companies in relatively few hands. More important, I worry that this will serve to reduce significantly the degree of diversity in our financial system.

The big five argue that, while the banking system itself is highly concentrated, because the four pillars tend to overlap, the financial market remains fairly competitive. I think that, to some extent, this is true. The four pillars have also promoted diversity in financial markets.

If we follow the proposal in the Green Paper, what is likely to happen? I think it would be only a matter of time before the chartered banks lobbied successfully for the same treatment. Then, in a relatively short time, I fear that those big five, along with a few of the larger financial holding companies now in existence – Trilon, Power, E-L – would come to dominate all of what is now encompassed by the

four pillars. In other words, I fear that if we are not careful, we could end up with our entire financial system dominated by a few firms and, on balance, less competitive than it is now. I think our experience with oligopolies in this country should not lead us to think this would be good.

I am not saying this will happen, but I am saying that it is enough of a fear that we had best be very careful with what we are doing.

CONCLUSION

An analogy that is sometimes used in discussions of the regulation of financial institutions is that of the department store versus the specialty store. I think that is a suggestive analogy. We do not find the Bay and Eaton's pushing other retailers out of the market – in fact, lately the trend has been the other way. I think that consumers are well served by this diversity. Similarly, I think consumers in the financial market are well served by the diversity offered there.

In my opinion, it would be undesirable if, in trying to improve a financial system that, even with its defects, is a relatively good one, we stacked the deck in favour of the department stores.

Comments

Philip Anisman

I have a few preliminary comments. A number of people have decried the publication of papers by government bodies, viewing them as the antithesis of direct action. I like writing papers; they are fun. I must concede that my enjoyment is not a sufficient reason for the government to publish more of them. But I noticed that a number of the speakers who preceded me favour consultation by government with affected persons prior to action. The consultation process is frequently initiated and invariably furthered by papers. Papers not only permit a comprehensive analysis of issues, but they are also developed before legislation is drafted and, hopefully, before views are fixed. The question is one of the proper balance.

We have heard about the purpose of securities regulation. I agree that one of the purposes of securities regulation is investor protection. I do not agree that it is the only purpose. Rather, it is an intermediate purpose that is related to notions of confidence.[1] But confidence can also be overvalued. It has often seemed to me, for example, that in this country the concept of confidence in the market has been used to justify just about anything a securities regulator wants to do at a particular time. It is always necessary to ensure investor confidence; yet I have never seen a survey taken of what constitutes investor or other confidence. I do not mean to controvert the relevance of confidence, but it should not be used as a substitute for analysis.

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We have heard today that a constitutional amendment should not be sought because the amendment process is cumbersome, slow and uncertain. We have heard that we should move ahead with regulatory means rather than worry about jurisdictional processes. I am on record as advocating a constitutional amendment to give the federal government plenary, concurrent authority over the securities market.[2] I still think that is right. I do not deny the views that have been expressed – in fact, I agree with them – that the ultimate purpose of regulation, of law, is to serve people, that we should deal with social issues rather than legal issues, and that social goals should govern the legal norms that are developed. But in a market as dynamic as today's, with constant change, with increasing development of new instruments, with new technology which encourages internationalization and a national marketplace, we cannot ignore the jurisdictional questions if we are to handle those matters on a regulatory basis. The legislative powers of Parliament and the provinces enable us to deal with such social issues. The development of a regulatory scheme necessarily involves the constitutional basis for enacting it. In short, we must address both.

The focus of this panel is on the comparative benefits of federal and provincial regulation with some emphasis on the experience with regulation of the securities market. There are a number of reasons for federal regulation of markets. The reasons usually given are that a market may be national and international in character and that there is a need for uniform regulation in order to reduce unnecessary costs and duplication. There are also questions of the ability, or inability, of provincial governments to define and regulate issues relating to a national market; the national market system proposed by Pierre Lortie raises such issues. Increasing internationalization creates difficulties of enforcement and provides opportunities for fraud, for example, through insider trading and even with respect to the raising of capital.[3] As well, technological developments permit internationalization of markets, as is demonstrated by the recent links between the Montreal and Boston exchanges and the proposed links between the Toronto and American exchanges. Provinces simply cannot deal fully with such international markets.

On the other side, the arguments made in favour of provincial or local regulation are that it is more sensitive and better able to respond quickly to local needs and demands, can help to develop local markets,

is closer to the people and can thus address new developments in changing markets, and also provides a series of forums for experimentation with regulatory devices that otherwise could not be maintained.

These are stark extremes. There is no need to talk about exclusive federal regulation or exclusive provincial regulation, which both of these descriptions may assume to some degree. In a federal system a tension necessarily exists between desires for uniformity, for consistency of treatment across the country, and for diversity to accommodate local needs and desires. Such tensions inhere in any federal system, and will be here as long as Canada is one. And they do not exist only between provinces and the federal government. Uniformity has been espoused here by William Pidruchney, and the provincial securities commissions have made a number of attempts to achieve uniformity in order to accomplish some of the goals just outlined as motivating national regulation. I might point out that we no longer talk about uniformity, but about compatibility of systems and their harmonization; and Mr Pidruchney favours 'integrated' regulation, though I have to say that he referred only to local regulation of financial institutions.

Everyone is in favour of harmonization of laws. The Green Paper espouses harmonization; it does not define what that means but it espouses it. The provincial securities commissions have long espoused and sought harmonization of their regulations. Even constitutional lawyers believe in harmonization of laws. It is a nice ideal, but as with most things, it is a little more difficult to achieve than to state the ideal. The provincial securities commissions, for example, have sought uniformity of legislation in one form or another since the 1930s. The early securities acts in this country were attempts at uniform legislation; they failed to attain it. The Ontario Securities Act of 1978, which was developed after seven years of consultation with the other provinces through the Canadian Securities Administrators, was supposed to lead to a uniform national system. There are still moves in that direction, but the legislation that has followed the 1978 Act has not been uniform and has not always been harmonious.

The reasons for that also inhere in federal systems. There are differences in the time required for enactment of provincial legislation. Ontario passed its Act in 1978; the Alberta Act came into

effect three years later. During the interim period, new problems appeared, new issues had to be dealt with, some of them in response to the Ontario Act and to deficiencies discovered in it. The Alberta Act attempted to compensate for some of those deficiencies, creating differences of detail. Thus, although the ultimate aim was harmony, differences of detail crept in.

With diversity of regulation differences of policy are inevitable. Different commissions and governments have varying views on desirable policy in a given area. To use the same examples, the legislation in Alberta did not adopt Ontario's follow-up offer requirement for takeover bids, namely, that a person who buys a control block of shares at a substantial premium make the same offer to all the shareholders of the acquired company. Alberta simply rejected a follow-up obligation as a matter of policy. And its rejection led to a number of interjurisdictional difficulties.[4]

I do not want to overemphasize such difficulties. The provincial commissions for some time have engaged in co-operative efforts under the rubric of the Canadian Securities Administrators. They meet twice annually to discuss policy development with each other, and they have taken substantial steps toward harmonization. About a year ago I completed a study of the attempts by the provinces to develop harmonization between their laws.[5] Rather than limiting my research to the policy statements and the acts, I reviewed all the commission orders for the preceding two years to see what they actually did. I discovered that while there have been consistent efforts at uniformity among the provinces, they have not always been effective. In fact, their effectiveness varies with the nature of the effort, the area being regulated and the need for uniformity. I shall give a very cursory overview of some of the things I discovered.

Co-operation of some sort is manifest in every area of Canadian securities regulation. I analysed the treatment by regulatory area, looking first at disclosure, then substantive policy, enforcement and ultimately registration of dealers and advisers and the stock exchanges. (The exchanges as self-regulatory organizations (SROs) are themselves a form of registrant; SROs, subject to review by the commissions, are in many respects engaged in a registration process with their regulator.[6])

Co-operation has worked best with continuous disclosure filings. Everyone seems to agree that it does not make sense to enforce minor

differences in the details of information required to be disclosed by a corporation or to require multiple differentiated filings that have to be prepared continuously because of different filing or disclosure periods. As a result there has been a substantial amount of accommodation. Some difficulties have arisen because of shorter time periods in Quebec,[7] but inconvenience from such differences has generally been minimized through the use of exemptions by the commissions. And it was encouraging to hear Mr Pidruchney say that the provincial commissions are considering the possibility of single filings through the use of a national electronic communications system.[8]

The usual example of provincial uniformity is the prospectus requirements. The first national policy adopted by the provincial commissions created a system for national clearance of prospectuses for distributions of securities made across the country. Although this question had been a major concern since the 1930s and had generated informal administrative accommodation, the first formal policy statement was adopted in 1969. The policy had a primary jurisdiction do the vetting; the other provincial commissions would theoretically follow along within relatively short time limits unless they differed. While the policy worked generally, it did not work as well as was expected. In 1978 another national policy was adopted in an attempt to accelerate processing of renewal prospectuses for issuers that sell securities continuously and must renew their prospectus every year, the kind of issuer with which the least trouble would be expected. Nevertheless, some provinces did not agree on the merits of an issue and some were not as fast as others in sending their comments to the primary jurisdiction. In short, the national clearance procedure was less successful than is sometimes suggested.

The most recent development relating to prospectuses is a national policy permitting use of a short form prospectus that can be filed on an accelerated basis. This policy seems to have worked better, but its administration too has not been uniform. There were initially differences in the application and standards adopted by various provinces. Some of these differences have been ironed out, but there is still some question about the validity of the Ontario policy because it adopts a short form prospectus in a manner other than the one specified in the Ontario Act. This deficiency may create problems across the country.[9] Indeed, all of these problems, which would be dealt with once in an integrated system, are multiplied by the

diversity that flows from provincial regulation. And the attempts at harmonization have not removed them.

There are also problems with the 'closed system' adopted in the Ontario Securities Act of 1978. This system is based on the continuous disclosure requirements of the 1978 Act and has been adopted in the few provinces that have followed that Act. The theory of the 'closed system' is that no securities may be sold to public investors unless prospectus-equivalent information is generally available concerning the issuer. Thus although the statutes permit an issuer to distribute its securities without a prospectus through a number of exempt transactions, purchasers in such transactions cannot resell the securities so purchased unless the issuer is in the system, that is, unless it is a reporting issuer that complies with the continuous disclosure obligations of the legislation and has been so for a specified period of time. The issuer's continuous disclosure file provides an informational base on which investors may evaluate its securities. The whole system, however, is premised on the exempt transaction occurring in the regulating province. If it occurs outside the province, there is no prohibition against the purchaser (unless he is a control person[10]) subsequently entering the legislating province and selling the securities so purchased. The closed system is thus premised on a degree of harmony that the provinces have not yet achieved. The only ways to realize it would be to set up barriers to interprovincial transactions or to adopt uniform legislation across the country. Neither has happened.

The application of substantive policies relates to prospectus clearance, exemptions and takeover bids. The territorial limits on provincial jurisdiction are crucial with respect to such policies.[11] If a province develops a singular policy more stringent than those in the other provinces, an issuer will have two choices. It can comply, as Mr Lacoste mentioned, with the strictest jurisdiction and enter the province with a singular policy; or it can simply avoid that province and so deprive provincial investors of an opportunity to participate in the transaction. The latter path is not uncommon in the context of takeovers, and was followed, for example, in Edper's acquisition of control of Brascan through the American Stock Exchange.[12]

It is easy to avoid unique requirements by structuring a transaction so that no element of it occurs in the regulating province. Such conduct, however, may undermine the integrity of the provincial

regulatory system and force the local administrator to drop the requirement or lead him to attempt to shore up the provincial system. One of the more controversial issues in Canada in the past five years has been the Ontario Securities Commission's attempts to enforce its follow-up offer requirement by imposing cease-trading orders and denying the exemptions to people who engage in transactions outside Ontario that would have required a follow-up offer had they been conducted in the province. Indeed, the Commission's efforts have been one of the major reasons for a number of proposals to do away with the follow-up offer obligation in Ontario.[13]

All of these matters relate ultimately to enforcement and remedies. It is simply impossible for a single province acting alone to devise adequate remedies in a modern securities market. I shall offer only one example, the problem of fashioning a scheme of civil liability for market conduct, an issue now before both the Ontario and Quebec commissions. If an issuer publishes a false press release or fails to make timely disclosure in accordance with the provincial timely disclosure requirements, a general civil remedy might make it liable to any investor who suffers economic harm as a result of its statutory violation. The amount of such liability may be inordinate, for every person who trades in the market during a period when the price of the issuer's securities is affected by its false statement or failure to disclose is arguably harmed by the violation. This issue was debated during the preparation of the federal *Securities Market Proposals* and one possible solution to it is reflected in them, albeit with a dissent.[14] The unlimited liability that could be imposed on an issuer is simply too stark. The types of solution adopted have been ceilings on the amount of damages that can be recovered and limits on the time period during which the market price of securities will be viewed as having been affected by a violation, thus reducing the number of potential investors who may bring an action for damages. Neither solution can work if the liability scheme is imposed only in one province; a maximum limit on damages cannot be maintained if it is imposed in Ontario and someone can sue in Manitoba. The difficulties are further compounded if the disclosure obligations differ between provinces, as they do.[15] Clearly there is a need for harmonization.[16]

This brings me to registration. The provincial commissions have tried valiantly to co-ordinate the registration requirements with respect to national securities firms. The most significant problems

have occurred in the subject area of this conference, namely, overlap of function among financial institutions. A number of provincial commissions, primarily Ontario's and Quebec's, have considered ownership of registrants, whether it be public, foreign or institutional, and have attempted to find solutions. The two provinces have adopted divergent positions with respect to foreign ownership of securities firms, and the breakdown of the four pillars has led to similar differences between them with respect to institutional ownership of and non-securities activities by registrants.[17]

As my time is limited, I shall be brief. It is fine to talk about harmonious development of the regulation of these dynamic financial institutions in different provinces to accommodate provincial needs and policies and to permit competition between regulators. But co-ordinated provincial regulation may not, in fact, allow different regulatory regimes to have any effect where national institutions are concerned. Under functional regulation a financial institution from Quebec which wants to engage in business in Ontario must comply with the standards in the latter province, even if it is entitled to establish an investment subsidiary in Quebec. Similarly, a national securities firm carrying on business across the country cannot diversify because Ontario's regulations prevent such diversity even on a national basis.

I do not mean to oppose harmonization or co-operative efforts. I think they are essential. But the difficulties they present, both constitutional and otherwise, should not be underestimated. The constitutional hurdles alone are considerable, even with respect to co-ordination. For example, federal-provincial co-operation with respect to agricultural products marketing boards has existed since the 1930s. Yet in 1978 the Supreme Court of Canada declared certain provisions of one such co-operative scheme *ultra vires*.[18] And some of the attempts to accommodate that decision may be questionable. There is also substantial uncertainty about such schemes as a result of the *Dominion Stores* and *Labatt Breweries* decisions mentioned by William Moull earlier this afternoon, both of which were delivered within the last few years.[19] Thus, although some recent Supreme Court decisions can be viewed as inviting federal legislation to regulate the Canadian securities market,[20] the nature of a constitutionally valid regulatory scheme cannot be predicted with

certainty. In short, clear rules, if they are to be effective, may not be possible without a constitutional amendment.[21]

I should be hesitant about turning to SROs as a solution for financial institutions generally. The self-regulatory device was adopted in the securities market because there were existing stock exchanges that already performed a number of regulatory functions, and it was possible to build on what they already did. There was no need to create new SROs to perform regulatory functions. Introduction of SROs in a sphere where they do not already exist as regulators merely imposes a new level of regulation that may have perverse effects. I should consider that very carefully before advocating it.

Finally, I agree with Ed Neufeld's comment that we should not simply follow what other jurisdictions have done. The Australian co-operative scheme of securities regulation was suggested earlier today as a model for Canada. It is based upon the existence of uniform federal and state legislation and a National Companies and Securities Commission, which directly regulates takeover bids and stock exchanges and otherwise establishes policies to be administered by the state corporations commissions, all subject to the oversight of a Ministerial Council (which also exercises supervisory jurisdiction over the national commission's activities concerning stock exchanges). The Australian scheme has not worked as well as might be inferred from its conceptual structure. Although the national commission determines policy, it cannot implement it because the state commissions are responsible for direct regulation and the state commissioners, who must operate within local budgets, select their own priorities. Moreover, there have been some difficulties resulting from lobbying in the ministerial council. Indeed, many Australians are of the view that exclusive federal regulation is necessary.[22]

In conclusion, I merely reiterate that a constitutional amendment giving Parliament concurrent legislative authority over the securities market may be necessary if effective and efficient regulation is to be attained. The increasing internationalization of securities markets around the world (presenting regulatory problems not unlike those facing the provinces), developing communications technology, the national character of the Canadian market, and the inevitable limitations of provincial regulation, despite conscientious efforts at harmonization, make the involvement of the federal government in securities regulation inevitable. The recent developments with

respect to financial institutions, and especially the erosion of the four pillar concept, provide further demonstration of the need for a co-ordinated national system of regulation. A constitutional amendment would facilitate a co-operative regulatory scheme that could accommodate both local and national needs in a truly harmonious manner.

NOTES

1 And ultimately to the efficiency of the market with respect to the raising of capital; see, e.g., P. Anisman *et al.* (1979) *Proposals for a Securities Market Law for Canada* (Ottawa: Supply and Services Canada) vol. 1: Draft Act, s. 1.02; vol. 2: Commentary, 1-5 (hereinafter referred to as *Canada Securities Market Proposals).*

2 See, e.g., P. Anisman (1981) 'The proposals for a securities market law for Canada: purpose and process', 19 *Osgoode Hall Law Journal* 329, 365-67.

3 For a regulatory attempt to move toward greater harmonization of securities regulation as a result of increasing internationalization of primary securities markets, see the concept release of the US Securities and Exchange Commission concerning multinational securities offerings; SEC Securities Act Release No. 6568 (28 February 1985), [1984-1985 Transfer Binder] *CCH Federal Securities Law Reporter* para. 83,743. See also SEC Securities Exchange Act Release No. 21958 (18 April 1985), *ibid.*, para. 83,759 (requesting comments on issues relating to internationalization of securities markets around the world).

4 The experience with the Ontario requirement is described, e.g., in B. Bailey and H.P. Crawford (1983) 'The take-over bid by private agreement: the follow-up offer obligation', 7 *Dalhousie Law Journal* 93.

5 See P. Anisman, 'The regulation of the securities market and the harmonization of provincial laws', in Canada (1985) Royal Commission on the Economic Union and Development Prospects for Canada, *Harmonization of Business Law in Canada: Research Studies*, vol. 56 (forthcoming). The following discussion is based on this paper.

6 See, e.g., 1 *Canada Securities Market Proposals, supra* note 1, Part 9; 2 *ibid.* at 148- 52. Compare Securities Act, RSO 1980, c. 466, s. 22 (hereinafter Ontario Securities Act without cross reference);

Securities Act, Stats. Que. 1982, c. 48, Part VI (hereinafter Quebec Securities Act without cross reference).

7 The 1982 Quebec Act, following the *Canada Securities Market Proposals* and the reporting periods in the United States, originally required the filing of an annual statement within ninety days of the end of a reporting issuer's financial year and quarterly reports within forty-five days of the end of each of the three other quarters; see Quebec Securities Act, ss. 75-76; *cf.* 1 *Canada Securities Market Proposals*, *supra* note 1, ss. 7.01-7.02. The Quebec Act was amended recently to bring its requirements into line with those in the other provincial acts; see now ss. 75-76, as amended by Stats. Que. 1984, c. 41, ss. 27-28 (140 and 60 days, respectively).

8 See Anisman, *supra* note 5, text accompanying note 155.

9 For a fuller discussion see *ibid.*, text accompanying notes 184 to 213.

10 A person who controls an issuer is generally precluded from selling its securities, other than pursuant to an exemption, without filing a prospectus; see, e.g., Ontario Securities Act, ss. 1(1) 11(iii) and 52.

11 For a discussion of the territorial limit on provincial jurisdiction in this context, see generally P. Anisman and P. Hogg, 'Constitutional aspects of federal securities legislation', in 3 *Canada Securities Market Proposals*, *supra* note 1, 135 at 147-50.

12 See also *ibid.* at 148 (AGTL acquisition of Husky Oil).

13 For a fuller discussion of these issues see Bailey and Crawford, *supra* note 4; Anisman, *supra* note 5, text accompanying notes 295 to 364.

14 See 1 *Canada Securities Market Proposals*, *supra* note 1, ss. 13.07 and 13.09; 2 *ibid.*, at 237, 259-60 and 264.

15 Compare, e.g., Ontario Securities Act, s. 74 with Quebec Securities Act, ss. 73-74 (different standards imposing duty of disclosure).

16 The interjurisdictional implications of civil liability for disclosure documents and non-disclosures affecting the market are discussed more fully in Anisman, *supra* note 5, text accompanying notes 396 to 405.

17 See, e.g., *ibid.*, text accompanying notes 424 to 472; and see Ontario Securities Commission (1985) *A Regulatory Framework*

for Entry into and Ownership of the Ontario Securities Industry: A Report to the Minister of Consumer and Commercial Relations (February).

18 See *Reference re Agricultural Products Marketing Act*, [1978] 2 SCR 1198.

19 See *Dominion Stores Ltd.* v. *R.*, [1980] 1 SCR 844 (1979); *Labatt Breweries of Canada Ltd.* v. *A.G. Canada*, [1980] 1 SCR 914 (1979).

20 See *Multiple Access Ltd.* v. *McCutcheon*, 18 Bus. L.R. 138 (SCC 1982), at 153 (dictum). See also *Canadian National Transportation Ltd.* v. *A.G. Canada*, 49 N.R. 241 (SCC 1983) (*per* Dickson, J. concurring).

21 See Anisman, *supra* note 5, text accompanying notes 560 to 566.

22 See, e.g., R. Baxt, H. Ford, G. Samuel and C. Maxwell (1982) *An Introduction to the Securities Industry Codes*, 2d ed. (Sydney, Australia: Butterworths) 4, 16-17, 38-9. Within the last year both the federal and Victoria attorneys-general have advocated this position with respect to securities regulation and the Legal Committee of the Australian Business Council has also supported it.

Discussion

J. PEARCE BUNTING: I think we just have to recognize that there are certain forces at work. One of them was described this morning – conglomeratization. Clearly this is something that is happening now. I think we also have to recognize that there will be very strong pressures of internationalization of our markets. I think these are two driving forces that we have really not yet faced up to. Underlining them, particularly internationalization, is the fact that communications have, in terms of costs, become insensitive to distance, and the computer now allows us to do bookkeeping in a way that we could never do it before. Thus, the computer is allowing very complicated new products and procedures to be brought into being by the market.

The progress of these forces says to me that we should not try to stop the wheel from turning. We should try to direct our energies a little better than we have been doing. In terms of regulation, we are going to have to find ways for greater co-operation, at least between the federal and provincial levels.

DONALD MACDONALD: I made some public remarks over the last six months about the impact of foreign competition of all kinds on the Canadian market. I think it may well be that there are going to be different provincial viewpoints with regard to security markets to the degree that they are a zero-sum game – Vancouver's ambition, Montreal's ambition, and Toronto's – there is going to be competition. I think what Pearce just said about the impact of technology is important, and at a certain point external pressure is going to compel us to get together. Given the nature of the constitution, I think we are going to be hearing a lot about 'harmonization' in the future. It will perhaps not be harmonization in the narrow terms of wording of the statutes, but rather a harmonization of policy. I predict you are going to be seeing a lot of charts like the one of Jake's that you did not like earlier. There are going to be a lot of structures like that coming forth.

JOHN EVANS: I have little hope for harmonization between the federal and provincial governments. There has not been much in many other areas. Trying to regulate financial markets, and tighten up regu-

lations in financial markets, is like trying to squeeze jello. The tighter you squeeze, the more jello goes between your fingers.

Money moves too quickly; the markets are changing too fast. The markets, not the regulators, will dictate what the future is going to look like. I see an ever-increasing game of catch-up between the regulators and reality. As was mentioned earlier, 'I saw the hole, but as I kept moving out of the gate the hole kept moving ahead of me.' I think that is probably what the future of securities regulation looks like.

The more we try to impose tight regulation on the system, whether by the Green Paper approach, or what Ontario is proposing in some other areas, the more we will impose costs on the system. But the system will simply find ways to move around it. I think probably Quebec has the proper solution to the problem, and I am very taken by the fact that Parizeau's work of twenty years ago is finally being implemented. I think the federal government and the other provinces should have a good hard look at letting market forces work, rather than trying to regulate on a very specific basis and trying to co-ordinate all that regulation, which, as Phil points out, is simply not possible in the current situation.

JOHN HOWARD: In the short run, certainly, I would like to see a replication of Ontario's corporation and securities laws right across Canada. I think the practical issue – what we are doing now – is complying with that Ontario law simply because it is the most difficult one for us to comply with. The whole system has worked very well. We used to budget about thirty days to prepare and qualify a prospectus, and now we do it in seventy-two hours. However, that leads to what I think is going to happen in the long run. We can distinguish less and less between an issue of a securities prospectus and a bank loan or any other way of raising money. I feel very much, like John Evans, that the Parizeau approach is correct: not deregulation but a hell of a lot less regulation. We are going to be living in a far, far more fluid financial system, and I think the fluidity of it will start forcing us to simplify deregulation. That may be wishful thinking.

TOM COURCHENE: I would just like to comment on Phil Anisman's paper. I have read much of his other writings, including the monu-

mental study he has edited, *Towards a Securities Law for Canada.* I do believe there is a need for a federal role somewhere in the securities industry, but what Anisman tries to do is rewrite all the statutes and put the system under federal control. I think that is wrong. The impression one gets listening to all of this is that if there were a pervasive federal presence, all would be beautiful. But if you look at the United States and its federal approach, you could make the same comments as you make about Canada. We talked about Pierre Lortie a lot in this conference, but it seems to me that one of the things that Lortie has argued for long and hard was that yes, we must have national markets but this need not entail regulation by the federal government. My final comment is something I have learned from the Ontario Economic Council – for things to be national they need not be federal. And I think that the provinces have done a very good job in generating national securities markets.

PHILIP ANISMAN: I do not advocate a brave new world of federal re-regulation. But we must have a co-ordinated system and that will be achieved only with federal involvement.

PART IV: US AND UK EXPERIENCE

The regulation of US banking

George J. Benston

INTRODUCTION AND OVERVIEW

US banking regulations are largely the product of legislation enacted in the early 1930s, as a consequence of the Great Depression. In the ensuing fifty years, technology and markets have changed, and some laws have been modified, resulting in the present regulatory situation. The substantial increase in the level and variability of interest rates, together with the probably unintended effect of higher deposit insurance coverage enacted in 1980, has given rise to some serious concerns The paper outlines the official reactions to this situation, evaluates the proposals put forth, and assesses the prospects for change.

THE REGULATIONS OF THE 1930s

In 1933, following the failure of over 9,000 banks – about a third of the number in operation in 1929 – the US Congress enacted legislation that changed the banking system from one characterized by relatively free entry for banks (though not for branches) to a system in which entry, prices, and products were severely regulated. The principal constraints added included: the prohibition of explicit interest payments on demand deposits; controls on time and savings deposits (Regulation Q); separation of commercial and investment banking; and a general denial of new bank charters and encouragement of mergers.

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However, some important constraints were not removed. National banks continued to be subject to state-imposed restrictions on intrastate branching; interstate branching was not permitted, despite considerable evidence that the undiversified operation of unit banks was the principal reason for the large number of failures; and specialization in mortgages and savings deposits by thrift institutions was continued, since they were not given additional banking powers and were given tax reductions and other subsidies through the creation of the Federal Home Loan Bank Board and the federal home loan banks. Indeed, specialized home mortgage lending was encouraged and subsidized by the liberal granting of federal charters for savings and loan associations, the establishment of federal home loan banks to assist and lend funds to them, and the creation of federal agencies that guaranteed home loan mortgages.

Perhaps the most important change affecting today's operations was the creation of the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC). Deposit insurance, which is not priced to reflect the risk imposed by banks and thrifts on the insurance agencies, has now become the most important regulatory problem facing the US banking system.

RECENT CHANGES IN BANKING REGULATION

The constraints imposed by the legislation of the 1930s and deposit insurance worked well in virtually eliminating bank failures. Restrictions on entry gave banks (a term used hereafter to include all chartered depository institutions, unless otherwise stated) considerable equity investments in their charters. This investment, plus conservatism learned from the experience of the 1930s and the limited opportunities of the 1940s, gave bankers strong incentives to avoid excessive risks. The regulators continued to view bank safety as their primary goal. Indeed, very few banks were chartered; in the 1920s, an average of 361 banks a year were founded, compared to only 53 per year from 1935 through 1944, and 94 per year from 1945 through 1959. A change did not occur until James Saxon became Comptroller of the Currency (the regulator of national banks) in 1962. In just four years he approved charters for 514 national banks, twice the number chartered in the previous twelve years. In response, the states also increased the number of charters granted to an average of 124 per year over the 1962-6 period, compared to an annual average of 86 over

the previous four years. Entry into banking by other means was constrained by economic forces. As long as interest rates were low and stable, entrepreneurs and consumers had few incentives to get around the regulations by establishing and seeking out new institutions and products.

After inflation-driven nominal interest rates increased in 1965, Regulation Q ceilings were extended to savings and loan associations by the Interest Rate Adjustment Act of 1966. (Thrifts were allowed a higher rate to compensate for their not being permitted to offer a full range of banking services.) The controls were effective because market rates of interest were not much above (and were sometimes below) the ceilings until the late 1970s, when market rates increased sharply, reaching a peak of over 15 per cent in 1981. The result was the beginning of the effective deregulation of deposit banking.

Corporate borrowers and depositors increasingly used the commercial paper market as a means of avoiding the controls on deposit interest and the tax imposed by non-interest-bearing required reserves. Money market mutual funds (MMMFs) provided a way for depositors to obtain market rates of interest by offering them shares in US Treasury obligations and deregulated bank certificates of deposits (CDs) of $100,000 and above. MMMFs grew from $1.7 billion at year's end 1974 to only $3.7 billion in 1976 and 1977 (year ends). But they were $10.8 billion in 1978, $45.2 billion in 1979, $74.5 billion in 1980, $181.9 billion in 1981, and $206.6 billion in 1982.

In the 1970s, as a means of offering chequing services to its customers, one savings bank introduced interest-bearing chequing accounts in the form of negotiable orders of withdrawal (NOW) from savings accounts. The increase in market rates of interest led to the adoption of NOW accounts by banks and thrifts, until their use was limited to New York and the New England states by federal legislation. Merrill Lynch introduced the money management account, which paid interest and permitted unlimited third-party transfers by cheque.

The market-induced changes were finally recognized by Congress in December 1980. The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) allowed all depository institutions to offer NOW accounts to non-business customers (with $2,500 minimum balances and limited transfers), gave thrift institutions limited rights to offer chequing accounts and loans to individuals and businesses

(except where permitted by a few states, thrifts had been prohibited from offering other than most real-estate-related loans), and began a phase-out of the Regulation Q celings on time deposits. Required reserves were reduced, but all institutions offering third-party transfers were required to keep non-interest-bearing reserves with the Federal Reserve. DIDMCA also increased deposit insurance from $40,000 to $100,000 per account in any insured institution. This increase, which has contributed importantly to present regulatory problems, appears to have been instituted as a means of giving banks (that still were subject to the Regulation Q interest-rate ceilings) a means of competing with MMMFs for deposits. However, MMMF assets did not decrease until 1982, when banks were allowed to offer market rates of interest on money market accounts. Aggregate bank money market account balances went from zero to $375 billion in 1983, while MMMF assets dropped by $66 billion.

THE PRESENT SCOPE OF BANKING REGULATION

The US bank regulatory structure is rather complex. The following outline should be viewed as a very general overview, meant to give the flavour, though not the detail, of the regulatory situation in the United States.[1] For this purpose, five types of regulation are delineated: price, product, location, management, and taxation and subsidization. The regulation of foreign banks also is discussed briefly.

Price regulation

Federal law restricts the interest payments that banks can pay to depositors. Savings and time deposits have been and still are partially subject to Regulation Q ceilings, though these will be almost completely removed within the year. Transactions balances may not bear explicit interest if they are designated demand deposits. However, if they are called NOW accounts they may pay the Regulation Q savings deposit rate and the number of withdrawals by cheque is limited; if they are called Super-NOW accounts, they are subject to demand deposit required reserves but are not regulated as to interest or number of withdrawals. Neither type of explicit interest-bearing deposit may be offered to corporations.

Ceilings on interest charges are imposed by state-enacted usury statutes. Federal law has pre-empted these statutes for mortgages, but they still apply to consumer loans and, in some instances, to other loans. However, banks (such as Citibank) have centralized their consumer credit operations in states (such as South Dakota) that do not impose interest rate ceilings. At times down-payments and maturities have been regulated.

Products

Federal Reserve member commercial banks are prohibited by the Banking Act of 1933 from offering full service securities transactions and underwriting, with the exception of the general obligations of state and local governments and all obligations of the federal government. However, these banks can offer the services of discount brokers and transact in securities for trust accounts. Other commercial banks appear legally able to offer securities services, but they have not as yet been permitted to do so. Commercial banks cannot invest in corporate securities, invest in real estate not directly related to banking, invest in non-financial businesses, or sell or underwrite insurance. However, in some states, state-chartered savings banks and savings and loan associations can make such investments and savings banks can sell life insurance. In general, commercial banks are restricted from providing, either directly, via subsidiaries, or within a holding company, products other than those designated by the Federal Reserve Board as congeneric financial products. Savings and loan holding companies with but one savings and loan association, however, are not similarly restricted (though multiple savings and loan holding companies are restricted as are commerical banks).

Other corporations, such as retailers and securities brokers, can offer a wide range of financial services. They can also offer banking services and insured deposits by establishing 'non-bank banks'. This curiously named institution is technically not a bank for purposes of the Bank Holding Company Act, since a bank is there defined as an institution that both makes commercial loans and offers depository services. Until a moratorium was put on charters for non-bank banks in 1985 (after which a federal district court ruled that Congress has not intended to define a bank in such a limited fashion), brokers and others could contravene legal prohibitions on interstate banking by establishing non-bank banks in several states that did not make

commercial loans, but that offered all other types of banking services. They then could offer commercial loans through other subsidiaries.

Location

Commercial and savings banks may not take deposits at offices located in more than one state or within a state, except as permitted by state law. Savings and loan associations are not similarly restricted, though they have been permitted to have offices in several states only as a result of the mergers of failing institutions. States may permit 'foreign' bank holding companies to have subsidiaries, and several have done so for limited purposes (Delaware, Maryland, Nebraska, South Dakota, and Virginia), on a regional reciprocal basis (e.g., the New England states), to save a failing bank (e.g., Washington, when Bank America acquired Seafirst Corporation), or on a general basis (e.g., Alaska). In many states, consumer finance companies cannot open offices unless they can demonstrate that these offices serve the public's 'needs and convenience.' Credit unions are limited to serving 'affiliated persons,' such as members of a church, employees of a company, or residents of a neighborhood. Other suppliers of financial services, such as insurance companies, sales finance companies, and retail stores, are not restricted as to location (though insurance companies are state-licensed and regulated).

Management

Banks are subject to field examination and general supervision of their operating procedures, loan documentation and collateral, and practices with respect to consumer protection and other laws. Their officers also are subject to laws related to possible self-dealing and other conflicts of interests. While many of these laws (particularly the antidiscrimination laws) apply to other suppliers of financial services, these suppliers are not site-examined or as closely supervised.

Bank supervision is the responsibility of a number of agencies. State-chartered banks and thrifts are supervised by state banking departments. Some of these, such as New York, are well staffed, conduct regular field examinations, and have their own sets of rules that they endeavour to enforce. Other states restrict themselves to chartering and closing banks (or, in some cases, delaying the closing of banks). All but five states require their chartered depository

institutions to obtain federal deposit insurance. Though the recent failure of the Home State Savings Bank of Cincinnatti, Ohio, has led that state (one of the five exceptions) to change its policy, banks in the other four states (notably Massachusetts) obtain their insurance from private (though state-supervised) insurance agencies.

Nationally chartered banks are supervised and examined only by the Comptroller of the Currency. These banks must be members of the Federal Reserve and the FDIC. State-chartered banks that are Federal Reserve members are supervised and examined by the Federal Reserve, and FDIC-insured state-chartered banks are supervised and examined by the FDIC (as well as by the states). The Federal Reserve also regulates bank holding companies, regardless of where the subsidiary banks are chartered or whether under federal or state law.

Savings and loan associations (SLAs) are chartered by the states and by the Federal Home Loan Bank Board (FHLBB). The deposits in almost all SLAs are insured by the FSLIC, which is an agency of the FHLBB. Credit unions also are state- or federally chartered, and their deposits are insured by the National Credit Union Savings Insurance Fund.

Taxation and subsidization

The transactions balances held at banks are subject to reserve requirements. Because these reserves (which may be kept as deposits at the Federal Reserve banks or in vault cash) do not bear explicit interest, this requirement represents a tax on the users of bank-offered transactions services, particularly since the Federal Reserve was required (in 1981) to charge for its services. However, unlike other taxpayers, banks are not required to reduce deductible interest expense by tax-free interest income from state and municipal obligations (except to a small degree that is scheduled to increase gradually).

Federal provision of deposit insurance provides an important subsidy to many banks and SLAs. Deposit insurance premiums are not priced directly according to the risk to the insurance fund imposed by a bank. Since the insurance premium is assessed on all deposits but covers *de jure* only deposits up to $100,000 per account in each bank, the smaller banks that hold relatively few deposits over this amount were subsidized and the larger banks were penalized. However, the FDIC handled almost all failures of larger banks by arranging for an

assumption of the bank's total deposit liabilities by another bank, thereby protecting all depositors. When the Penn Square Bank of Oklahoma failed in 1982, this practice was not followed. But when doubts surfaced about the solvency of the Continental Illinois Bank, the FDIC feared a run and announced that all the bank's (and its holding company's) liabilities would be insured. Thus, very large banks again are seen as 'failure-proof', but there is uncertainty about the less-than-giant banks.

Foreign banks

Prior to passage of the International Banking Act of 1978 (IBA), foreign banks could establish a presence in the United States according to the laws of the individual states. At that time, twenty-four states permitted foreign bank agencies and twelve allowed branches. Unlike domestic banks, foreign banks could establish branches in more than one state, since they were defined as 'banks' under the McFadden Act. The IBA put the supervision of foreign banks under the Comptroller of the Currency and generally provided that foreign and US banks would be similarly treated, including branching as permitted to US banks and the provision of FDIC insurance to retail deposits.

PRESENT CONCERNS

It might seem that the inconsistent and untidy US regulatory structure would be sufficient reason for change. But if this were the case a change would have been made long ago. Rather, the most important impetus is the entry of unregulated suppliers of financial services as a consequence of high nominal interest rates and low-cost technology and the failure of banks and thrifts on a scale not seen since the Great Depression.

Entry of unregulated suppliers

Unregulated suppliers, particularly brokers (such as Merrill Lynch), insurance companies (such as Prudential Life), and department stores (such as Sears), began offering financial services to their customers for two principal reasons. One is the increase in interest rates and the Regulation Q ceilings that prevented chartered financial institutions from competing for consumers' funds. The second is the increasingly

lower cost of transferring and keeping track of funds resulting from considerable improvements in computers. As controls on interest rates, which previously saved banks from competing with each other, became ineffective for this purpose, and as brokers entered their markets, banks have asked for permission to offer a fuller range of services. Thus far, they have obtained only the right to offer discount brokerage services.

Failures

Thrift institutions failed in numbers not seen since the Great Depression, largely because of the unexpected increase in the level and volatility of interest rates. The thrifts held unbalanced portfolios that were long on fixed-rate mortgages and short on short-term savings and time deposits. They were profitable because their investments in mortgages were subsidized, first, by lower taxes geared to their mortgage holdings and, second, by underpriced deposit insurance that did not take account of interest rate risk. They also benefited from the Regulation Q ceilings on time deposits, as long as these were effective. But the interest rate increases of the late 1970s resulted in both severe capital losses on their assets and deposit drains as the public moved its funds to the market-rate MMMFs. The consequence was the official failure of 164 SLAs during the three years ended 30 June 1984.[2] Over the five calendar years 1980-4, some 510 SLAs either failed or were merged to avoid failure.[3] As of 31 December 1983, it is estimated that the net worth of mutual savings banks (restated on a market-value basis) is negative $12.3 billion and the net worth of SLAs is negative $73.7 billion.[4] While the thrifts were given the power to offer a wider range of assets and services, including variable rate mortgages, they are finding it difficult to restructure their balance sheets quickly. Thus, unless interest rates unexpectedly decrease, it is likely that more thrifts will fail.

Commercial banks experienced very few failures until 1982. Between 1943 and 1981, an average of six banks a year failed. The number jumped to 34 in 1982, 44 in 1983, and 42 through the first half of 1984 – 120 in all. Several factors appear responsible for the failures. Bovenzi and Nejezchleb studied the 120 failures in terms of the market conditions that might explain them.[5] They conclude: 'General economic conditions seem to have played a large role in higher failure rates.... Chief among these is the level of real interest

rates' (p. 67). In addition, higher failures were experienced in regions that had experienced booming economies in the 1970s, but were adversely affected by the downturn of the 1980s. These states also were ones where new banks were chartered at relatively high rates; these banks tended to fail 'at rates well in excess of what their proportion of the population would suggest' (p. 68). Deregulation, however, does not appear to have played a role. The 1982-3 failures also were studied by Short, O'Driscoll, and Berger.[6] They compared the financial statements of the failed banks and non-failing banks of a similar size in the same state. The analysis also was conducted for failed and non-failed banks in 1964 (a year of relative stability) and 1975 (when failures increased significantly). Deposit insurance was increased to $40,000 per account per bank in 1974 and to $100,000 in 1980. The analysis indicates that 'managerial decisions to accept more risk have played an important role in the determination of bank failures' (p. 3). An additional and, from previous US history, pervasive cause of failures is malfeasance by bank managers and owners. Using data presented in congressional hearings and gathered by the staff of the House of Representatives Committee on Government Operations, Peterson and Scott report that malfeasance was the principal contributing factor to the failure of 45 per cent of the 1982 failures and was related to the failures of an additional 36 per cent.[7] Among the failures in 1983 and the first quarter of 1984, malfeasance and malfeasance plus other factors were associated with 18 and 35 per cent, respectively, of the number that failed.

PROPOSALS FOR REFORM

Congressional reactions to the banking situation

Congressional reaction to the entry of unregulated suppliers and the failures of thrifts and commercial banks has been to hold hearings, berate regulators and bankers, and propose some legislation. Previously, the Financial Institutions Regulatory and Interest Rate Control Act of 1978 had established the Federal Financial Institutions Examination Council to co-ordinate the supervision and examination procedures of the federal agencies and to establish uniform principles, standards, and examination forms. A recent report by the General Accounting Office, however, charged that the Council was not successful in obtaining much co-operative action by the agencies.[8]

DIDMCA gave thrifts wider powers, partially lifted the ceilings on time deposit interest rates, and mandated reserves at the Federal Reserve for all purveyers of third-party transfer accounts. The Garn-St Germain Act of 1982 accelerated the deregulation of interest rates by providing for bank money market accounts. It also permitted interstate mergers where necessary to save failing institutions.

A number of additional bills have been proposed but not enacted. These variously would remove the non-bank bank 'loophole', widen the powers of banks to offer insurance, and restructure the supervisory agencies. Some congressmen have threatened to roll back deregulation on the grounds that the banks are unable to use the powers they were given – despite the evidence that the current problems are not at all related to the powers, but to their previous denial.

Deposit insurance agency proposals

As one of its provisions, the Garn-St Germain Act required the deposit insurance agencies to prepare studies of and proposals for change in federal deposit insurance. The FDIC and the FHLBB (of which the FSLIC is a part) prepared voluminous reports that discuss and summarize many of the important issues and are worth reading. Briefly, the FDIC recommends the following changes: reduction in effective insurance of deposits over $100,000 per account per institution to the proportional amount recovered (previously the FDIC had, in practice, almost always covered all deposits), deposit insurance premiums that vary with risk (three risk classes are proposed), increased capital through use of subordinated debt, public disclosure of supervisory actions against institutions, and the merger of the insurance funds, with the FDIC given sole responsibility to examine banks and thrifts.[9]

The FHLBB recommends the following changes: development of private insurance to supplement government insurance, use of risk-related deposit insurance premiums by insured institutions (including current value accounting of some sort), higher equity capital by insured institutions, and continuation of the FHLBB and the FSLIC as independent agencies.[10]

The National Credit Union Administration (NCUA) recommends that credit unions' risk exposure be limited by not having deposit insurance on small balances and by charging premiums for balances over $50,000; private insurance could be substituted for government

insurance. The present system of regulation and insurance would not be changed.[11]

Administration proposals

Two proposals have been made by the Executive branch. One is the result of a several-year effort by a committee chaired by Vice-President Bush, the members of which included the heads of all the banking and banking-related regulatory agencies and the secretary of the Treasury.[12] Among its recommendations are restructuring of the federal regulatory system that would, in sum, put the Federal Reserve in charge of almost all bank supervision and examination. The Office of the Comptroller of the Currency (retitled the Federal Banking Agency) would supervise all but the national banks that are subsidiaries of the largest holding companies or those with foreign branches; these would be supervised by the Federal Reserve. The FDIC would examine and supervise only those banks that were in danger of failing. The FHLBB would supervise SLAs and banks that could qualify as thrifts (institutions substantially involved in residential mortgages). Holding companies would continue to be supervised by the Federal Reserve, except that where the lead bank had a national charter, the Comptroller would be the principal supervisor.

The second proposal is made by a group headed by Undersecretary of the Treasury, Robert Healy.[13] Its recommendations are similar to those proposed by the deposit insurance agencies: risk-related deposit insurance premiums, increased equity capital (including subordinated debt), and improved accounting and disclosure.

EVALUATION OF PROBLEMS AND PROPOSALS

As outlined above, the principal problems facing the US banking system are disintegration of the regulations and barriers to entry imposed in the 1930s and increasing failures and risk-taking by bankers due largely to the incentives of underpriced federal deposit insurance. The various proposals for change address these concerns incompletely, in part because they do not consider the basic reasons for regulating financial institutions.[14] Among these reasons are several that once may have been but are no longer important. These include seignorage, fear of monopoly, support of social goals, conduct of monetary policy, and avoidance of financial crises.

No longer revelant reasons for regulation

I believe that governments in the past regulated banks primarily to capture the benefits from seignorage on money, which was an important source of revenue for those in power. While governments could (and did) obtain seignorage by coining and printing money directly, periodic abuses (such as debasement and overprinting) made government money suspect. Consequently, privately run banks had a comparative advantage in money supply, and they could be taxed through forced loans or partial ownership. Bank profits, and thus the amount that could be extracted, could be enhanced by giving the favoured bank a monopoly. Hence the practice of restrictive chartering.

In the United States, fear of monopoly banking (perhaps as a consequence of the colonialists' experiences with the Bank of England) and concern for state sovereignty were two (but not the only) reasons for interstate banking restrictions. But his fear has no present basis in fact, for three reasons. First, banks have for some time offered most financial services nation-wide, with no aggregation of power to a few institutions. On the contrary, the entrance by money centre banks into other areas and of international banks into money centres has decreased the possibility of concentrated power. Second, empirical studies do not indicate the dominance of a few banks by reason of economies of scale were branching not restricted; indeed, the data indicate diseconomies of scale.[15] Third, restrictions on entry serve to enhance whatever partial monopolies there may be, particularly where natural business areas include more than one state.

Support of socially desired goals, such as housing, has been used to support regulation, particularly the subsidized or forced specialization of thrift institutions. Recent experience, though, has shown this type of regulation to be dysfunctional. A considerable body of research also shows that directing and subsidizing credit for social goals is inefficient and rarely effective.

Monetary policy, whether directed toward control of the money supply, interest rates, or bank credit, also has been put forth as a reason for the regulation of financial institutions (particularly by the Federal Reserve). However, the central bank can effect monetary control entirely through open market operations. The regulation of financial institutions and services is not at all necessary – indeed, it often gets in the way of effective monetary control. Furthermore, only a subset of the activities of bank regulatory agencies have anything to

do with with monetary policies; most 'soundness' regulation is totally unrelated.

Financial crises can be obviated by the central bank's maintaining aggregate bank reserves. Bank runs (which could be offset by central bank actions) have been completely eliminated by the provision of federal deposit insurance. Government-provided deposit insurance, though, exacerbates the regulatory problem, as is discussed next.

Present reasons for regulation

Deposit insurance has created incentives toward risk-taking since depositors have been absolved of the necessity of monitoring bank operations and bankers need not be concerned about the fears of depositors. As present and past experience with state-sponsored deposit insurance shows, this situation gives rise to a serious moral hazard problem, which necessitates regulation. A complete discussion of the problems and alternative solutions cannot be provided here.[15] However, considering that elimination of *de jure* or *de facto* government-provided deposit insurance is not politically feasible, an important conclusion is that banking regulation should be directed primarily toward reducing the moral hazard from deposit insurance by increasing the incentives of bankers to avoid excessive risks rather than by restricting the activities in which bankers can engage.

The other reason for regulation is that some people benefit thereby. These beneficiaries include government agencies, users of financial services, and providers of financial services.

The Federal Reserve, as central bank, finds it useful to have a constituency of banks that must look to it for permission to do things that they want to do. The regulated banks also might find the Federal Reserve's regulation desirable as compared to some other agency, because they perceive that it needs their support in other matters. The chartering agencies would have little to do were charters not required. Hence their interest in continuing this form of regulation and the supervision that goes with it. As noted above, the deposit insurance agencies have an interest in reducing the costs that would be imposed on them.

Most users of financial services would benefit from complete deregulation. In particular, restrictions on all forms of entry – via providers, products, locations, and prices – work to their detriment. Some users, however, benefit from regulations that direct credit

toward them. Such US laws include the Community Reinvestment Act and the Equal Credit Opportunity Act. The housing industry, in particular, has benefited from the direction of funds to mortgages. However, as noted, recent experience indicates that that situation is often undesirable and is not necessary.

Some regulated providers profit from regulations that restrict competitors from opening offices in their areas. Banks and thrifts have gained, in the short run, from ceilings on the interest rates they could offer depositors. But, as they competed less efficiently with 'free' services and as alternative investments were designed by entrepreneurs, this situation became detrimental. Unregulated providers of financial service benefit from regulations that prevent banks from competing with them. These providers include securities brokers and underwriters, insurance agents and underwriters, and travel agencies.

PROSPECTS FOR CHANGE

The present proposals for regulatory change are the latest in a very long line. Almost none of the previous proposals was adopted. Such regulatory changes have rarely been enacted, I believe, because those who would gain from deregulation (predominantly consumers) find it less costly to overcome the opposition of those who benefit from the status quo. However, regulations do change, for two principal reasons. One is the effect of incentives for innovations that allow suppliers to avoid the regulations. As the opportunity value of such innovations has increased, the regulations have become less meaningful and, hence, less profitable to established institutions. Second, crises force change. One such crisis was the Great Depression. We may be in a crisis now, caused by excessive risk-taking and bank failures induced by deposit insurance. If things get bad enough, we may change the system. But if past experience is a guide, the change need not be for the better.

NOTES

1 For a detailed description, see Carter H. Golembe and David S. Holland (1983) *Federal Regulation of Banking, 1983-84* (Washington, DC: Golembe and Associates) and for a more complete outline see George J. Benston, in George J. Benston, ed.

2 George J. Benston (1985) 'An analysis of the causes of S&L failures'. Monograph series in Finance and Economics, Salomon Centre, New York University.

3 James R. Barth, R. Dan Brumbaugh, Jr, Daniel Sauerhaft, and George H.K. Wang (1985) 'Thrift-institution failures: causes and policy issues'. Paper presented to the Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, 1-3 May.

4 Edward J. Kane (1985) *The Gathering Crisis in Federal Deposit Insurance* (Cambridge, Mass.: MIT Press, Tables 4-5 and 4-6).

5 John Bovenzi and Lynn Nejezchleb (1985) 'Bank failures: why are there so many?' *Issues in Bank Regulation* (Winter), 54-68.

6 Eugenie D. Short, Gerald P. O'Driscoll, Jr, and Franklin D. Berger (1985) 'Recent bank failures: determinants and consequences'. Paper presented to the Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, 1-3 May.

7 Richard L. Peterson and William L. Scott (1985) 'Major causes of bank failures'. Paper presented to the Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, 1-3 May.

8 Comptroller General of the United States (1984) *Federal Financial Institutions Examination Council Has Made Limited Progress Toward Accomplishing Its Mission*. Report to Congress, General Accounting Office GGD-84-4, Washington, DC, 3 February.

9 Federal Deposit Insurance Corporation (1983) *Deposit Insurance in a Changing Environment*. A Study Submitted to Congress by the Federal Deposit Insurance Corporation, Washington, DC, April.

10 Federal Home Loan Bank Board (1983) *Agenda for Reform*. A Report on Deposit Insurance to the Congress from the Federal Home Loan Bank Board, Washington, DC, March.

11 National Credit Union Administration (1983) *Credit Union Share Insurance*. A Report to the Congress Prepared by the National Credit Union Association, Washington, DC, April.

12 George Bush (1984) *Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services*, Washington, DC, July.

13 The Working Group of the Cabinet Council of Economic Affairs (1985) *Recommendations for Change in the Federal Deposit Insurance System*, Washington, DC, January.

14 For supporting arguments and documentations of the conclusions given here, see George J. Benston (1982) 'Federal regulation of

banking: analysis and policy recommendations'. *Journal of Bank Research* (Winter) 216-44.

15 The issues are analysed in George J. Benston, Robert A. Eisenbeis, Edward J. Kane, George G. Kaufman, and Paul M. Horvitz (forthcoming) *Ensuring the Safety and Soundness of the Nation's Banking System: An Analysis of Policy Alternatives* (a study prepared for the American Bankers' Association), MIT Press.

The changing structure and regulation of the British securities markets

Richard A. Brealey

INTRODUCTION

The British securities markets are undergoing rapid change. For example, in the last few months the government has published a White Paper on market regulation, the stock exchange has produced proposals on membership changes, and the Bank of England has made proposals on the structure of the gilt-edged market. Whatever I say today stands a considerable chance of being outdated tomorrow.

Regulation of the British securities markets is a curious but not ineffective mélange of self-regulation, statutory intervention, and informal suasion. Security dealing is governed by an extensive set of Stock Exchange rules, and in addition investor associations such as the Unit Trust Association and the British Insurance Association help to maintain professional standards. Statutory control relies on a number of separate British statutes and EEC directives, of which the most important are the Prevention of Fraud (Investments) Act and the Companies Acts.

Thus there is no single statute governing the conduct of business, and there is no single government agency or self-regulatory body. The decentralized nature of market regulation has led to periodic calls for a central regulatory agency, and it was partly to defuse these demands that the Bank of England in 1978 established a co-ordinating body, the Council for the Securities Industry (CSI). Although the CSI has few resources and no real power, it has provided a forum for the discussion

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of investor protection and is a vehicle for the informal suasion exercised by the Bank of England.

Recently two developments have caused the issues of regulation and protection to be reopened. In 1978 the Office of Fair Trading brought an action against the stock exchange before the Restrictive Practices Court, which led to an agreement between the Secretary of State for Trade and Industry and the stock exchange, whereby the exchange agreed to implement certain reforms. These fundamental changes in the exchange's rule book and in market structure make some change in supervision almost inevitable. In addition, in 1981 the Secretary of State commissioned Professor Gower to undertake a broad review of the regulatory structure and to make recommendations for reform. The Gower Report in turn led to a 1985 White Paper proposing a new framework for investor protection.

In this paper I shall initially discuss the nature of official regulation of the securities markets, and I will then describe the current structure of the stock exchange and the proposed changes to its rule book. I will then consider the issue of market regulation under the new structure, and finally I will comment on questions of investor protection that arise from purchases of shares for acquisitions.

STATUTORY REGULATION

The operation of the securities markets is subject to both British and EEC law, though in general the EEC directives are less restrictive than British legislation.

The principal statute governing securities investment is the Prevention of Fraud (Investments) Act of 1958. This act provides that:

1 Dealers in securities must be licensed by the Department of Trade and Industry (DTI) and are then subject to the Department's Conduct of Business Rules.

2 There is a class of 'exempted dealers' consisting mainly of merchant banks and insurance companies whose principal business is not dealing in securities.

3 Members of certain recognized bodies, of which the Stock Exchange is by far the most important, are also exempt from the need to obtain a licence to deal. However, such bodies are expected to have rules of conduct that are at least as extensive as those of the DTI.

As well as imposing rules of conduct for licensed dealers, the 1958 act makes it an offence for anyone dealing in securities to make deceptive promises or forecasts and (with certain exceptions) prohibits the distribution of circulars that are invitations to deal.

MARKET STRUCTURE

There is only one stock exchange in the United Kingdom, and the vast majority of transactions in British government and company securities is undertaken through the exchange. As noted above, the DTI delegates its rule-making powers to the stock exchange, and a comprehensive set of rules governs trading on the exchange. Three of these rules are particularly significant. First, there is separation of capacity between the market maker and the broker. In other words, the jobber, who acts solely for his own account, is for the most part allowed to transact only with other members of the Exchange, and the broker in return offers all his business to the jobber. Second, and in view of the stock exchange inseparable from the first, the brokers charge a minimum level of commission. Third, outside firms are prohibited from acquiring members of the exchange. Thus member firms operate broadly similar businesses, and at least among brokers or among jobbers there is considerable uniformity of interest.

Despite the dominance of the exchange, it has been subject to competition in a number of areas:

1 The issuing houses were responsible for the establishment of an automated dealing service, Ariel. Although Ariel captured only a trivial proportion of stock exchange business, the threat was partially responsible for the exchange's decision to reduce commissions on large bargains.

2 The formation by Granville and Company of the so-called 'Over-the-Counter Market' was a partial inducement to the Exchange to establish the Unlisted Securities Market for companies that could not meet the requirements of a full listing.

3 The exchange does not have an equivalent dominance of newer markets. Whereas options are traded on the exchange, the Eurobond

market is an interbank market and financial futures are traded on the London International Financial Futures Exchange (LIFFE).

4 Fourth, when dealing in international markets, jobbers have needed to be able to deal on a net basis, and this has led the exchange to relax its prohibition on dual capacity.

5 Finally, in recent years there has been an increasing tendency for licensed dealers and exempt dealers to make markets in listed securities. For example, the merchant bank Robert Fleming is now reputed to handle approximately 12 per cent of the dealing in electrical stocks.

Although the exchange's rules had been coming under increasing strain, change was precipitated by the Restrictive Practices Court case and the subsequent agreement with the Secretary of State to implement certain reforms. These included the abolition by 1986 of minimum commissions and the removal of the current rules on single capacity.

Before looking at the exchange's proposed new structure, it is worth considering briefly the economic consequences of the change to negotiated commissions and dual capacity.

NEGOTIATED COMMISSIONS AND DUAL CAPACITY

Minimum commissions need not confer abnormal profits but may simply induce competition in service rather than price.[1] Indeed, the fact that there has been exit from the industry suggests that this may have been the principal consequence. If so, we cannot judge the benefits of negotiated commissions by the reduction in commission rates. Instead we need to focus on the effect of reducing the volume of information generated by brokerage houses.

Security analysis has two purposes. One is to forecast future cash flows and in the light of these forecasts to modify future consumption plans. Such research is a public good and would not be produced in sufficient quantity if left to individual investors. The second and probably much more important purpose is to uncover misvalued securities with the intention of realizing private gains. These predatory activities by some investors will oblige others to gather information to protect themselves. Information that is collected for predatory

purposes is, therefore, a deadweight cost, and the value of securities to investors is reduced by the present value of these costs.

Security analysis by brokerage firms is widely disseminated and therefore helps to protect investors from would-be predators. Thus, brokerage research may substitute for private research, and, since it may avoid expensive duplication of research departments, it could reduce the deadweight costs of producing information. When minimum commissions are abolished in 1986, this co-operative system of providing research as a defence against predators will vanish, and, if the only alternative is private research, we would expect security values to decline.

However, this is not the whole story. Since all information-gathering costs reduce the value of a company's securities, removal of minimum commissions may result in the transfer of information production from brokerage houses to the company itself. If companies produce the information more efficiently than brokers, company values should rise by the associated cost savings. While on balance this seems the most likely outcome, the general point is that the impact of negotiated commissions is relatively complex and cannot be judged simply in terms of changes in commission levels.

Consider now the effect of the removal of single capacity. Both in its defence of the current jobbing system and in its proposal for a system of registered market makers, the stock exchange has stressed the importance of continuous markets and the need to provide market makers with an incentive to offer the service. If there were no costs to continuous participation in the market by all investors, there would be no need for a jobber to take positions. Investors who wanted to sell stock could simply put it up for auction and be certain that they would receive a fair price. Since in practice such a continuous public auction would be costly, few investors leave a continuous set of limit orders, and orders accordingly arise in a 'lumpy' and haphazard fashion. If there were no market maker, there would be large short-term variations in price, which would depend on the precise sequence of orders. It is for this reason that it is worth paying a jobber to make a market.

Market makers do not undertake extensive security analysis. Instead they form their estimate of the equilibrium price by observing the sequence of orders that they receive. If the stock is risky (i.e. the equilibrium price is changing) or if orders are 'lumpy', the market

maker is more likely to estimate incorrectly the equilibrium price. Since the error variance in the estimate of value decreases with the market maker's share of the business, there are significant pressures toward centralization in market making.

The spread charged by any market maker is a function of the degree of information asymmetry.[2] Market makers face the problem that they can only lose to the well-informed, and so, if they are to continue in business, these losses must be offset by the gains from dealing with traders who are not motivated by superior information. Therefore narrow spreads by market makers are possible only when there is little information-motivated trading.

Where information asymmetries in a market are potentially large (e.g. the market for second-hand cars), spreads are wide. Where there is little information asymmetry (e.g., the market for treasury bills), spreads are narrow. No one suggests that second-hand car dealers should receive special privileges to enable them to make continuous two-way prices on even the most doubtful cars, and it is difficult to see why market makers in equities should be given such inducements. A market maker will be prepared to quote narrow spreads in the face of information asymmetries only if the consequential losses to well-informed traders are offset by payments from other traders. Thus the obligation to make continuous two-way markets must result in an increase in aggregate trading costs and provides a conduit to transfer funds from the less-informed to the better-informed.

It is also frequently argued that single capacity eliminates the conflicts of interest between principal and agent. If these conflicts are a matter of wide concern, then we would expect to observe firms advertising that they act solely as agents, and licensing rather than voluntary certification would be necessary only if there were substantial costs to verifying the firm's status. In any event, under the exchange's proposed new structure, member firms will be obliged to disclose for each deal the capacity in which they act.

THE PROPOSED STRUCTURE FOR THE STOCK EXCHANGE

The stock exchange's (1984) proposals for a new market structure were set out in July 1984. The system of single capacity buttressed by minimum brokerage commissions is to be abolished. In its place the exchange proposes a system modelled on NASDAQ. Member firms will consist of broker-dealers who may act both as principals and agents as

long as clients are informed in which capacity they are acting. Broker-dealers may also register as market makers and thereby accept the obligation to quote continuous two-way prices in specific stocks. Market makers may operate on or off the floor, but all quotes will be displayed to member firms through the stock exchange Automatic Quote system (SEAQ). In the continued belief that continuous markets merit a subsidy, market makers will receive certain privileges.

1 They will be entitled to reduced stamp duty on transactions.

2 They will be able for tax purposes to net dividends on long and short positions.

3 Broker-dealers who are not market makers will also be able to trade as principals only if they can offer a better price than is offered by the market makers.

To strengthen the exchange's monopoly power or reduce free-riding (depending on your viewpoint), member firms will have privileged access to information. For example, they will receive quotes by individual market makers, whereas non-members will receive only the average bid and offer prices.

The belief in the need to subsidize continuous market making also extends to the proposals for reform of the gilt-edged market (Bank of England 1985). Again, it is proposed that market makers on the exchange will receive privileges for making continuous two-way prices (and for satisfying the Bank of England's capital requirements and accepting its prudential oversight). These privileges include a direct and exclusive dealing relationship with the Bank, borrowing facilities at the Bank, exclusive access to the inter-dealer broker mechanism, and tax privileges when borrowing and lending stock.

It is difficult to escape the view that the Bank of England's concern for a special relationship with gilt-edged market makers is as much aimed at facilitating its own open-market operations as at improving the competitiveness of the secondary market.

In March 1985 the exchange published its proposals on membership (Stock Exchange 1985). These envisaged that shares in the Exchange will be made transferable and that member firms will be required to purchase a minimum of 50 shares. The proposal generating the most

heat among member firms was that from March 1986 stock exchange firms may be owned by outside institutions.[3] In anticipation of this development, clearing banks, merchant banks, and overseas banks have been acquiring minority interests in brokerage and jobbing firms. In many cases the motives for these acquisitions are ill-defined, and purchasers appear to have paid substantial sums for what is at best an insurance policy. However, one of the main consequences of this wider ownership is that the exchange will embrace a wider variety of interests than hitherto and as a result may find it increasingly difficult to maintain agreement among its members. Heterogeneity of interests is perhaps the best guarantee of competition.

PROPOSED CHANGES TO MARKET REGULATIONS

It would be naïve to suppose that some supervision of the securities markets is not needed. First, many of the participants are in an agency relationship, and some monitoring of their activity is therefore necessary. There is a strong case for having a single body to do this. Second, if clients cannot distinguish the quality of rival professionals, low-cost incompetent practitioners may drive out of business the higher-quality ones. This creates a need for either licensing or voluntary certification.[4] Moreover, even if only the competent can obtain a license, the client may still find it difficult to judge whether a particular action was *ex ante* justified, and some regulation of investment activities therefore may be desirable. Third, and more arguably, traders outside the central market may be able to free-ride on the information-gathering activities of the exchange, and this could lead to underproduction of information.

The debate in the United Kingdom has focused not on the need for regulation but on the adequacy of the existing structure and the relative merits of self-regulation and government regulation. While the existing mixture of self-regulation and statutory regulation has led to few major problems, the stock exchange is already committed to changes in its rule book. These changes and the growth in new markets that are often off the floor of the Exchange are likely to place the present system under increasing strain. One problem with the system is that there are a number of gaps or inconsistencies. For example, the insider trading provisions of the 1980 Companies Act refer to trading only in the company's securities and not in traded

options. A second problem is that many of the prescriptions lack teeth and both civil and criminal proceedings under the Prevention of Fraud and Companies Acts are rare. Thus there have been only two prosecutions under the 1980 Act for wrongful insider dealing.

Professor Gower's preference (HMSO 1982) was to establish a single Securities Commission with broad regulatory powers, but he rejected this solution as being politically impracticable. He recommended instead a system of self-regulation within a new statutory framework. Gower proposed that a new Securities Act should replace the Prevention of Fraud (Investments) Act and parts of the Companies Acts. This Act would make it an offence to carry on business in securities (widely defined) unless registered with the relevant self-regulatory agency that in turn was registered with the DTI. He envisaged a minimum of four such agencies: one being the stock exchange, another an enlarged Panel on Takeovers responsible for both new issues and acquisitions, the third being responsible for those engaged in dealings off the exchange and for investment advice and management, and the fourth being a catch-all agency responsible for those engaged in dealings off the exchange and for investment advice and management.

In January 1985 the government set out its own proposals (HMSO 1985). These retained the spirit of the Gower recommendations, but they aimed both to build more on existing self-regulatory bodies and to establish a central regulatory authority. The intention is to introduce a new Investments Act to cover investment in all financial assets. Two regulatory boards will be established – the Securities and Investments Board (SIB) and the Marketing of Investments Board (MIB). SIB and MIB will in turn recognize self-regulatory bodies such as the stock exchange as long as they control the admission and conduct of their members and provide standards at least equivalent to those of the boards themselves.

All investment businesses would need to obtain authorization either directly from one of the boards or through membership of a recognized self-regulatory organization. This requirement will apply to firms of broker-dealers, investment managers, promoters, and advisers, though there will be an exemption for certain groups such as accountants, solicitors, and newspaper publishers for whom investment advice is an incidental part of their business.

In the particular case of the gilt-edged market, the Bank of England will monitor the capital adequacy of market makers, money brokers, and inter-dealer brokers. This will be based on a complex and arbitrary numerical scoring system. The stock exchange will monitor the capital adequacy of other members participating in the gilt market and will also regulate the trading practices of the market. All these requirements will be subject to SIB's overview.

To obtain authorization any investment business will be required to demonstrate that it is 'fit and proper.' If it is refused membership by an approved self-regulatory body, the business will be able to apply to the appropriate board for direct authorization and will have an ultimate right of appeal on that decision to a tribunal. Once authorized, the business will be subject to the rules of the board or self-regulatory body. The Investments Act will establish the following general principles for these rules:

1 To guard against conflicts of interest, all businesses will be subject to a principle of fair dealing, a duty of skill, care, and diligence, and a duty of disclosure. In addition, agency businesses will be subject to a 'best execution' principle and a duty to disclose the capacity in which they are acting.

2 Clients' assets must be held in a segregated trust account.

3 Compensation will be available for clients who have incurred loss as a result of an infringement of the rules by the investment business.

4 Investment recommendations must be adequate and reasonable, recognizing the circumstances of the client.

5 The full terms of business must be disclosed to clients.

6 Proper records must be maintained.

7 Arrangements must be adequate to ensure the orderly conduct of business (e.g., by prohibiting market manipulation).

Other provisions of the act will relate to the specific activities of unit trusts, insurance companies, and pension funds and to the manner in which they are marketed.

Enforcement of the rules will be the responsibility of the relevant self-regulatory body or the board, and sanctions will include revo-

cation of the offender's authorization to practice. In addition, criminal actions may be initiated by the injured party or the Secretary of State for

1 Conducting an unauthorized investment business.

2 Issuing misleading and reckless statements or undertaking acts likely to deceive.

3 Making a public offer (including those as part of takeover bids) without a full prospectus.

4 Insider dealing, which will be widened to cover all securities.

There are several apparent motives behind the government's proposals. The licensing requirement and the capital adequacy and compensation regulations stem from the difficulty that customers may experience in distinguishing the experts from the charlatans. A more dominant motive underlying such principles as 'best execution' and 'diligence' is to monitor at low cost the activities of agents.

There are certain attractions to the government's proposals. First, it is likely to be less costly to build on existing bodies than to create a single regulatory agency. Second, these bodies have the necessary expertise and information to regulate the conduct of business. Third, they are more likely to be able to do so in an informal way that recognizes the spirit rather than the letter of the law.

It is well known that professional associations may have an incentive to restrict entry by imposing licensing requirements that go beyond the public interest (see Leland 1979). Given the economic pressures toward a central market system, we should expect the stock exchange to continue to impose high standards of conduct, and, because it can discipline individual members and registered representatives, it is well placed to enforce its code of conduct. The danger in this case is not that standards will be too lax but that competition will be impaired.

For deals that are outside the market system the converse may be true. The DTI has had neither the resources nor the will to police the activities of licensed dealers, and it is unclear that this problem will be resolved by simply shifting it onto SIB. As long as there are substantial economies to a central market or advantages to stock exchange certification, it would be possible for dealers subject to

differing standards of conduct to co-exist. If these conditions do not hold, the standards imposed by any of the self-regulatory bodies will simply decline to the minimum standards imposed by SIB or MIB.

Many firms may find that they are members of regulatory bodies with different rule books. For example, a bank subsidiary that is a member of the exchange is clearly subject to exchange rules when dealing with another subsidiary that is a member, but if this second subsidiary were then free of exchange control, the rules of the exchange could be effectively bypassed. The exchange envisages that in such cases it will be able to look through to the activities of the rest of the firm, but how effectively it can do this (particularly in the case of overseas firms) and what jurisdictional problems this will cause remain to be seen.

A widespread concern with the changes in exchange rules is that they will exacerbate conflicts of interest. It is arguable, however, both how far this is so and how far regulation can help. Many 'conflicts of interest' problems are principal-agent problems. In such cases we cannot usefully ask the agent to act against his own self-interest (as is envisaged in the White Paper); we can only change the nature of the contract to make his interest coincide with that of the principal. Since failure to devise such a contract leads to inefficient production decisions, both agent and principal have an equal interest in devising efficient contracts. The possible role of regulation is, therefore, limited to reducing the costs of such arrangements by standardizing the form of the contract and (more importantly) monitoring compliance. Other conflicts of interest may simply stem from information asymmetries. For example, one of the government's concerns is with the selling practices of investment institutions. Few people are under any illusions that salesmen act in their own self-interest and have an incentive to sell the lowest-quality product for the highest price. The difficulty is not that people are unaware of the salesman's motives but that he has potentially more information than the customer about product quality. Given that the problem is endemic to cases of information asymmetry, the only possible scope for regulation is to enforce disclosure. However, all except the lowest-quality producers already have an incentive to disclose, and the salesman for higher-quality products will either provide verifiable information or will signal the quality of the product. Obliging companies to undertake only single activities will not generally solve these problems, and, if it

weakens the opportunity to signal by brand naming, it may make matters worse. In summary, I am suggesting not that conflicts of interest are matters of little concern but only that they pervade all commercial activities and there are severe limits to the extent to which regulation can help.

MERGERS AND ACQUISITIONS

Investor protection on the occasion of acquisitions is closely allied to the regulation of the securities markets. The principal regulatory body is the Panel on Takeovers and Mergers which was established in 1968 on the initiative of the Bank of England and which is now an arm of the Council for the Securities Industry (CSI). The panel is responsible for enforcing the CSI's rule book on mergers, known as the 'City Code on Takeovers and Mergers.' This lays down a set of general principles and specific rules that seek to ensure that takeovers are conducted fairly. The City Code and the Companies Acts together establish four trigger points for a potential acquirer:

1 A potential acquirer who owns 5 per cent of a prospective acquiree must disclose its stake.

2 A company owning a controlling interest of at least 30 per cent of the acquiree's equity must make a bid for the remaining share capital.

3 Any offer for a majority interest must normally be conditional and can only be declared unconditional after the firm has acquired more than 50 per cent of the acquiree's equity.

4 If a bid results in the company's acquiring more than 90 per cent of the remaining equity, then the acquirer may purchase compulsorily the minority interest. Conversely, minority interests may require that their shares are bought.

It is common to estimate the profitability of mergers by examining the abnormal returns to shareholders at the time of the merger announcement. There is, however, a temptation to place unjustifiable reliance on these estimates. After all, those returns are at best an unbiased estimate by investors of the true gains from merger, and it remains possible that investors are no more able than economists to distinguish these gains. Moreover, the population of mergers is not given by

nature, and the distribution of returns on merging stocks is likely to be a decision variable in subsequent mergers. Despite these caveats, it seems fairly clear that acquirees as a group benefit from mergers and that acquirers roughly break even. On the surface, therefore, the former need little protection as a group, though the wealth gains may not be uniform across shareholders.

Grossman and Hart (1980) argue that worthwhile mergers may be frustrated if the minority interests in the acquired firm can free-ride on the benefits brought about by the acquirer's management. If each shareholder in the acquiree firm sought to free-ride in this way, it would be impossible for the acquirer to capture any part of the merger benefits. One suggested solution is that acquirees should be enabled to expropriate part of the wealth of minority interests, but such a solution could result in a degenerate equilibrium where the majority always has an incentive to acquire the minority. In two respects British regulation exacerbates the free-rider problem, since it requires early disclosure of the purchase of a 5-per-cent shareholding and since the City Code contains an underlying principle that oppression of minorities is unacceptable. However, the provision that companies can compulsorily acquire minority interests protects the acquirer in a rough-and-ready way against free-riders.

A second motive for regulation centres on the possible conflicts of interest between management and shareholders. In particular the shareholders of potential acquirees need to ensure that it is not in the interests of management to frustrate bids that would benefit the shareholders. On this issue British merger regulation relies largely on a passivity principle that states that at no time after an offer has been made or is imminent shall the board of the acquiree take without shareholder approval any action that could effectively frustrate the offer. Specifically, unless already committed to do so, it must not issue new shares, buy or sell assets of material amount, or enter into contracts other than in the ordinary course of business. This passivity principle is buttressed by specific rules:

1 Directors must act in the interest of the shareholders.

2 Directors of the acquiree must seek competent independent advice.

3 No relevant information shall be withheld from the shareholders, and they shall have adequate time to make a judgement.

4 Any information given to a preferred suitor should be available to a less welcome but bona fide potential offeror.

Even if acquirers as a group do not appear to be an oppressed race, it is still possible that gains are shared unequally among different shareholders. One example of the scope for wealth transfers arises from the two-tier bid. If all shareholders accept the two-tier offer, then each will receive the mean of the two bid prices, and, if this figure is below the firm's value, then it will not pay any individual shareholder to accept the offer. Conversely, if no shareholders accept, then there is an incentive for the individual shareholder to break ranks and accept. This presents shareholders with a many-person 'prisoners' dilemma'. The main provisions in the City Code against inequities between shareholders are that:

1 Information shall not be furnished to some shareholders but not to others.

2 If an acquirer purchases 15 per cent of the equity, then any subsequent offer within a 12-month period cannot be at a lower price than any of the earlier purchases.

3 Where control of a company is acquired (defined as a 30 per cent holding), a general offer must be made to all shareholders.

The City Code does not have the force of law. The Panel, therefore, has had to rely largely on censure, with the ultimate sanction that the exchange can deprive offenders of the facilities of the securities markets. In a few cases the Panel may refer aspects of a case to the DTI. These sanctions are inadequate. Action by the stock exchange may often harm the shareholders more than the offending management, and there have been a number of instances where brokers and merchant banks have deliberately flouted the City Code. The government's proposals for investor protection envisage a largely unchanged role for the Panel, so that the problem of enforcement is unlikely to diminish.

CONCLUSIONS

There have been two broad tendencies during the past twenty years in government attitudes toward financial markets. The first has been to

encourage more competition, and the second (not always consistent with the first), to increase regulations aimed at investor protection. I have focused in this paper on regulation of securities trading by investors and by acquiring firms. But the same tendencies can be seen in government banking policy, where the policy of 'competition and credit control' has been accompanied by an increase in prudential supervision.

As securities markets become more diffuse and competitive, the likely response will be demands for still more surveillance. How far the government's proposed structure will survive such demands depends on the resources and resolution shown by SIB and MIB. If these are lacking, then the current proposals for a mixture of self-regulatory bodies and supervisory boards will prove only an interim solution, and they will in time give way to a single regulatory body with strong statutory powers.

NOTES

1 This discussion is adapted from Brealey and Hodges 1978.
2 This was first noted by Bagehot 1971.
3 Since I prepared this paper, the exchange members have voted in favour of admitting outside firms but rejected the proposal permitting individual members to transfer shares to firms. Because the Bank of England envisages that firms of gilt-edged market makers will acquire Exchange membership, the exchange's vote could result in the gilt market's being placed outside the exchange.
4 For a discussion of the role of licensing and certification see Leland 1979.

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Changes in the US financial system

Robert C. Clark

I cannot comment on Professor Brealey's paper because it did not arrive until this morning. Professor Benston's paper poses a different problem. He did a wonderful job. The paper contains a clear and concise account of major legal rules affecting the US system and how they have changed. As for his evaluative remarks near the end of the paper, I find myself in agreement with most of them. So instead of airing a few minor quibbles with particular points in his paper, I would rather spend this time telling the story of the changes in our financial system from a somewhat different perspective.

I would like to talk to you today about the ongoing structural changes in financial institutions and financial markets in the United States. I'd also like to explore some possible reasons for the changes and some of the consequences of the changes, especially for regulatory systems. I will also discuss a historical parallel to these structural changes that occurred with respect to industrial corporations.

MAJOR STRUCTURAL CHANGES IN THE FINANCIAL SYSTEM

Let me start by setting up a somewhat fantastic, science-fiction type of background in order to imagine what things might look like to non-vested interests. Suppose an exploratory spaceship from the Andromeda Galaxy has landed quietly on earth, in the United States. Its highly intelligent crew includes not only the usual microbe hunters and anthropologists but also a business historian, Dr Chandler, and a financial economist, Dr Brealey-Benston. Captain

Robert Clark is professor of law at Harvard Law School.

Cook requests Dr Chandler to investigate the financial situation in the United States and to report back. The captain's parting words are: 'Focus on important, interesting, major things. Don't get bogged down in details.'

What would Dr Chandler's report look like? Fortunately, I have purloined a copy and can read it to you.

'Memo to the Captain. The most amazing things have been happening to the US financial system over the last twenty years. I've grouped them under four headings.

Homogenization

A few decades ago, the different types of financial institutions were easy to tell apart. Each had a fairly restricted repertoire of characteristic activities and sources of funds. But more and more, they have been getting into a wider set of activities – and into each other's business niches – so that they all seem to be becoming more diversified, and somewhat more like each other.

There are lots of examples of this:

– Starting in the 1960s, insurance companies began offering a great and increasing variety of equity-based products in which the pure insurance element receded and the investment element came to the fore. These included variable annuities and variable life insurance and, later on, single-premium deferred annuities and universal life policies. Many life insurance companies began acting more like investment companies.

– The statutory powers and actual activities of credit unions have steadily been expanded. A look at successive versions of the federal credit union statute confirms this: all the numerous changes in their powers have been one way – toward expansion and diversity.

– Securities firms, in the late 1970s, began sponsoring money market mutual funds and cash management accounts, both of which had elements of banking services in them.

– Thrift institutions, long confined to residential mortgage lending, began making consumer loans, commercial loans, and more non-residential real estate loans.

– In the 1980s, commercial banks began, in large numbers, to offer discount brokerage services to their customers.

Amalgamation

A second kind of change was the combination of different kinds of financial companies within the same holding company system. Obviously, these changes are just like the first kind, except that they were carried out at a different organizational level. Again one can list a variety of examples.

– In the 1960s, insurance companies began sponsoring and advising mutual funds through affiliated advisory companies. Bank holding companies (BHCs) have been trying to do so since then, but have been hindered by legal constraints.

– Throughout the 1970s, BHCs set up and acquired hundreds of finance companies, mortgage banking firms, and financial leasing companies throughout the United States.

– Around 1980, noteworthy combinations of savings and loan associations and finance companies were made.

– Some large insurance companies made news by acquiring prominent broker-dealer firms.

– Later on, numerous securities firms and insurance companies began setting up 'non-banks' – firms chartered as banks under some banking statute but not engaged in both taking demand deposits and making commercial loans (and therefore not a 'bank' for purposes of the federal Bank Holding Company Act).

Geographical expansion within the United States

Examples of this third kind of change are:

– BHCs acquired operations throughout the country through their acquisition of commercial and consumer finance firms, financial leasing, and credit card companies.

– Some states liberalized their in-state branching laws. A state allowing no branching would permit county-wide branching. A state with county-wide branching might allow state-wide branching.

Virtually no changes went the other way. Automated teller machines were considered branches, but they proliferated anyway.

– For a while, thrifts sought brokered deposits around the country – a kind of geographical outreach.

– In recent years, more and more states have enacted regional banking laws. Some have been even more liberal in their statutory invitations to out-of-state banks. Bank mergers and BHC acquisitions of banks across state lines but within regions began occurring.

Internationalization

Our fourth and final kind of change was internationalization:

– Over the last few decades, the percentage of business done by US banks abroad has greatly increased.

– At the same time, the presence of foreign banks in the United States increased dramatically.

If you were reading carefully, Captain, you will notice that I've talked about seventeen particular kinds of changes – for each of which I could give several or several dozen concrete examples – yet there are many other related ones. Obviously, these changes are not random, separate, and independent events. They are all cut from the same cloth; they fit together in some way.

To put it in two words, the financial institutions have been experiencing great *expansion* and *conglomeration*. We have here a system that is undergoing not just growth, but major structural changes. It is as if the financial system of this country were imitating some of its insects. The caterpillars here eat and grow, eat and grow, but at some point they undergo a metamorphosis and emerge with a radically different structure – as butterflies.'

Captain Cook wrote back a note: 'How do you know the emerging system won't be more like a moth? How do you know the structural changes aren't more like the metastasis of a cancer than the metamorphosis of an insect? But I'll leave those questions for later. I suggest that you extend your research by looking a bit at the history of real business corporations too.'

Time passes and Dr Chandler returns with her second memorandum.

'I've looked at real business corporations too and have gone back yet a few more decades into their history. I've discovered an astonishing parallel. Manufacturing and industrial corporations underwent a similar process of expansion and conglomeration, though it started and flourished at an earlier time. The analogies are even more intriguing when one pursues them in detail.

In the late 1920s, top managers of a few giant, publicly held corporations (e.g., Dupont and General Motors) began moving their companies toward a different organizational form. Previously, their largest internal divisions were based on *functions*: manufacturing, sales, and finance, for example. Now, their largest internal divisions would be separate *profit centres* that were nearly complete companies in their own right, with their own subdivisions based on functions. One profit centre made Chevrolets, another Buicks. Each had it own sales force, and so on. The corporation as a whole became a kind of miniature capital market. Each profit centre would be rewarded or punished for its performance by central headquarters, which could direct the flow of company funds and other resources.

The companies experienced definite economies from this reorganization, which earthling economists like Oliver Williamson of Yale have analysed at great length. The companies became able to grow much larger than a comparable functionally organized firm could grow without becoming unmanageable.

In the next several decades, more and more big companies adopted the new form, both in the United States and, after a lag, in virtually all the noncommunist developed countries. A Harvard business historian, Alfred Chandler, along with his students and followers, did much work to document this fact.

The next part of the story occurred because the new multidivisional form allowed *very diverse* business operations to be conducted efficiently within one corporate organization. In the 1960s, this possibility was realized in the United States. A wave of conglomerate acquisitions occurred, and large conglomerate firms became a permanent and numerous new species of animal in the business world.

And note this parallel too. The widespread conglomeration of real business corporations occurred on the heels of a great increase in the proportion of total business revenues accounted for by publicly held

corporations, that is, after a period of rapid relative growth of such corporations. Similarly, the wave of financial conglomeration that began in earnest in the 1970s occurred on the heels of a great increase (over several decades) in the percentage of total financial assets (stocks, bonds, notes, deposits, policies, etc.) that were issued by financial institutions, that is, after *their* period of rapid relative growth. These two separate periods of rapid relative growth – of large publicly held corporations and of financial intermediaries – were labelled the second and third stages of capitalism by a Harvard Law School professor (one Robert Clark) who studied and wrote about them.'

REASONS

After reading this, the captain decided that the time was right to call in the economist. She said, 'Dr Chandler has uncovered some definite and interesting trends, but I'll be darned if I can figure out *why* they have occurred. Analogies to insect metamorphosis aren't helpful because I don't understand that either. Work on an explanation. And since these are decades-long, widespread, unified phenomena, remember to focus on the long-run forces that may be responsible, not on occasional factors and triggers, such as oil-price shocks.'

After a hard day of theorizing, economist Dr Benston-Brealey submitted a tentative first report. It read:

'You asked for a possible explanation of the dramatic trend toward the expansion and conglomeration of financial institutions. Here are my initial thoughts.

The general form of my explanation is that technological advances made the conglomeration process economically feasible, and that people's preferences led to attempts to realize these possibilities. Both elements of the explanation are necessary factors.

Technology

Great improvements in communication and data processing, due in part to the rising use of better and better computers, had the important effect of making better connections among the different kinds of financial markets – the stock markets, the bond market, the market for government securities, and even the secondary market for mortgage-backed securities. Prices and rates of return in all these

markets became more and more interrelated. As a consequence, it became harder and harder to find a significant, long-lasting disparity between risk-adjusted rates of return in these markets. If a discrepancy popped up – if a 'bargain' was available in one of the markets – that fact would be discerned and communicated more quickly, thanks to the new technology, to players in the other markets, who would flock to the bargain opportunity until their investment activity made it disappear. So the several kinds of financial markets became both more efficient and more interconnected. They became more like One Financial Market.

At the same time, and for the same reason, financial markets in different countries and in different regions of countries became more interrelated to one another. In a geographical sense, too, the financial markets moved toward unity.

A closely parallel consequence of the improvements in communication and data processing power was that new kinds and combinations of financial services became economically feasible. Consider, for example, the idea of investor accounts that (a) represent an undivided interest in a large pool of money market instruments, (b) provide for numerous partial transfers by means of cheques, and (c) have investment minimums that put them within reach of millions of small investors. Such a thing, whether sponsored by money market funds or by banks, probably only became financially feasible with the development of efficient, computerized record-keeping.

Incidentally, this example illustrates the superficiality of a common theory. It is sometimes said that the driving force behind most recent financial innovations in the United States, including the conglomeration trend, is the desire to circumvent regulation. Thus, it is argued, if banks had been free in the mid- and late 1970s to pay any interest rate on any of their deposits, the whole money market mutual fund phenomenon would not have occurred.

This argument is right in a narrow sense, but it misses the broader, more important issue: why was it only at this time in history that small, chequable, diversified money market accounts, whether offered by mutual funds or by banks or by something else, arose and grew rapidly? The answer to that more fundamental question depends on technology and consumer preferences. The desire of financial firms to circumvent regulation helps only to explain the precise *form* of the new development.

Distinguishing the substance from the form of financial innovations has some importance for policy makers. Often, those who stress the 'circumvention of regulation' theme have an axe to grind. Sometimes they want the financial conglomeration process to look more arbitrary and historically accidental than it is, in order to make opposition to facilitative changes in the law appear more reasonable, or to make actions that try to halt or reverse the trend seem more realistic. In Canada, as far as I've heard it, the theme is sometimes used as part of a misleading argument to the effect that Canadians can't learn much from developments in the United States, since so many of them depended on the peculiar form of American legal regulations.

Consumer preferences

As stated, technology may have made the conglomeration process possible, but it doesn't explain why human beings strove to make the possibility real. One important factor is simply that consumers appear to like the new packages of financial services. They like financial supermarkets. They like money market accounts. They like being able to get their homeowner's or automobile insurance in the same place where they get their home or auto loans. They like investment-oriented insurance products. They certainly like being able to use plastic cards to access automated teller machines any time of the day or night in any part of the country. The evidence on the strength of such preferences is not formal and complete, but it seems foolhardy to deny the basic point that they exist.

Firm preferences

A more subtle point is that the ability to diversify their activities allows financial institutions to achieve a given level of riskiness in a more efficient way. For example, depository-type institutions like savings and loan associations could become less likely to fail if they switched some of their lending activities from home mortgage loans to short-term business loans. Ability to diversify allows financial institutions to become safer, or to go after business opportunities that are better than those available by simple expansion of their old lines of business.

Granted, the ability to diversify and to engage in a wide variety of types of financial activities can be exercised in a way such that the

riskiness of the institution is very high. Portfolio theory teaches us that a widely diversified portfolio can be created to have a very high beta, that is, to be very volatile and therefore risky. Granted, too, that the existence of deposit insurance, the premiums for which are not risk-related, tempts depository-type institutions to raise the overall risk level of their institutions to a point that is much higher than they would choose in the absence of such insurance. I do not mean to deny that these factors create serious problems for regulators. My point is just that, depending on how narrow and specialized a financial institution's starting portfolio of assets and liabilities is, diversification and conglomeration may make it possible to achieve a given level of riskiness of operations – whether a high level or a low level – in a more efficient way.'

EFFECTS

After reading Dr B.B.'s report, Captain Cook was deeply puzzled. She called the economist in for a chat.

'I think I now have some idea as to why the trend toward financial integration and conglomeration is occurring,' she said. 'But I'm curious about its likely effects. Let's take three areas: effects on efficiency; effects on the soundness of financial institutions; and effects on the regulatory process.

'First, as to allocative efficiency. What impact will the conglomeration process have on concentration and competition? Won't it lead eventually to a few giant financial enterprises controlling all the financial markets? Won't that result in an oligopolistic state of affairs that would harm the earthlings' economy?'

'No,' said Dr B.B. She took a deep breath and tried not to sound condescending. 'Both the immediate and the longer-term effect of broadening an economically meaningful financial market, geographically or in terms of services, is to increase the number of competitors. For example, if the state of communication and integration of financial markets is so poor that an economically meaningful market is commercial banking in the Boston area, and if four banks have 80 per cent of the deposits and loans in that market, then perhaps competition is in serious jeopardy in that market. But suppose that, because of better linkages, better information processing, and helpful legal changes, the effective market suddenly becomes the market for financial services in the entire United States (or even the world). The

same activities of the same four banks then become an infinitesimal threat to competition, because the banks have many more real competitors. And no four firms are going to acquire 80 per cent of the world-wide financial services market in anything like the foreseeable future. Thus the general effect of the integration trend should be to increase competition. When the market broadens, it also deconcentrates.'

'Very interesting,' said Cook. 'Now how about impacts on the safety of financial institutions? That, of course, has been a major concern of regulators of these institutions. Won't the integration trend increase the rate of financial institution failures, perhaps to an unacceptable degree? Surely the trend to diversify and expand will tempt managers to enter fields where they lack expertise. And surely the onslaught of new competition you just described will push many previously insulated financial institutions over the brink?'

Dr B.B. thought for a moment. 'The two particular scenarios you conjured up – some venturing by managers beyond their competence and some failures of previously insulated firms – will undoubtedly occur to a certain extent.

'But the overall effect need not be a weaker, more failure-prone system. Indeed, just the opposite is likely to be true. Once many financial institutions have diversified and conglomerated, they are less likely to fail than they previously were. When the fortunes of different lines of business do not co-vary in a perfectly positive way, combining them instead of operating them in separate companies may, other things being equal, reduce the chance that the businesses will have to go into expensive insolvency proceedings.

'To be sure, other forces, like the perverse incentives created by the deposit insurance system, may offset this effect of diversification and conglomeration. But in and of themselves these things promise to help the financial system become more sound.'

The captain, obviously determined to find something radically wrong with the integration trend, tried a new tack.

'What about effects on the regulatory process?' she asked. 'Won't the trend toward conglomeration make the job of the regulators more difficult? I assume that when financial intermediaries have substantially more diverse sets of activities, it becomes harder to devise good means of measuring risk and good rules for controlling and/or

pricing risk. Won't all the efforts at soundness regulation have to be re-examined and perhaps revised?'

'Yes,' Dr B.B. admitted. 'That, I suppose, is the price of progress in the financial world.'

'And might it not be a price that is too high to pay?' persisted the captain. 'So high that perhaps the earthlings ought to try to slow, halt, or even reverse the process of financial conglomeration?'

'Probably not,' said the doctor. She reflected a moment. 'Indeed, they really ought to be more concerned about the high price of not changing regulations fast enough to accommodate the new trends.'

The captain was incredulous. 'But how can that be? Isn't it always more prudent to go slow?'

'Absolutely not. Consider the case of thrift institutions in the United States. For years, savings and loan associations were bound by law and custom to be extremely specialized in their activities and to have a dangerous mismatch between the terms of their assets and liabilities. They had fundamentally unsound structures, largely because of activity limits mandated by law. They were, by virtue of their legal definition, essentially subject to severe risks of illiquidity and even insolvency if interest rates should rise unexpectedly high. The obvious long-term remedy to this unsound structure was to give thrifts greatly expanded statutory powers, and even to encourage them to use such powers, so that they could both diversify their activities and better match the terms to maturity of their assets and liabilities.

'Did this happen? Yes, but only after a wave of failures of thrift institutions was well under way (and essentially irreversible), and then only grudgingly. Regulation changed to allow activity expansion, but the change was too little and too late. That is, there was an awful lot of bloodshed – transition costs, we economists are supposed to call it – that could have been avoided.'

'But,' said the captain, 'couldn't the lawmakers have responded to the thrifts' problem in some other way than by selective deregulation? Couldn't they have simply kept the narrow and restrictive laws about thrift institution activities, and simply used public monies to bail out those thrifts that failed in periods of high interest rates?'

The economist stifled her incipient expression of outrage at the thought of bailouts. 'Of course they could have done that,' she sighed. 'But it would have been stupid to do so. The amount of money needed

would have been enormous, an economically inefficient business structure would have been continued and made able to cause future trouble, and no good public purpose would have been served.

'To repeat: it is simply not true that gradual deregulation is always best. Sometimes it can be catastrophic. And continuing, selective deregulation of some sort seems unavoidable, unless the earthling lawmakers want their society to incur large and avoidable costs.'

'Why do you say that the deregulation should be selective, rather than complete?' queried the captain.

'Because the regulatory system has purposes that most people still want to pursue – protection of small investors and protection of the stability of the financial system. One major reason why these goals still depend on regulation is that financial institutions are subject to severe conflicts of interest. Fraud and self-dealing have always been major reasons why they have failed. Ordinary corporate and securities law hasn't been enough to handle those problems.'

Captain Cook thought about the enormous difficulty of the delicate task faced by the earthling lawmakers and regulators. 'I don't envy their job,' she concluded. 'It will be interesting to see whether they have both the wisdom to facilitate the new trends and the ingenuity to achieve their valid regulatory goals.

But while we wait for the outcome, let us return to our own galaxy, where we have none of these problems. Perhaps some day they too will have a really advanced civilization, and they can speak to us as equals.'

Comments

Edward P. Neufeld

It is a very considerable pleasure for me to participate in this conference. It is also of great relevance for my ongoing preoccupations these days in the bank. I congratulate the joint convenors, Professors Waverman and Ziegel, for both the contents of the program and the timing of the conference.

The task assigned to me was to comment briefly on the papers presented by Professor George Benston and Professor Richard Brealey, the former on US developments and the latter on the British situation. But of particular interest, I understand, was the question of the relevance of developments there for Canada. That is the question I will briefly address.

RELEVANCE FOR CANADA OF US/UK EXPERIENCE CAN EASILY BE OVERESTIMATED

Much of financial system 'deregulation' and 'restructuring' really involves undoing distortions caused by past decades of regulation. Since the regulatory frameworks of the United States and Britain have been quite different from Canada's, so are the details of many of the consequences of 'deregulating' them. I can give a number of examples.

US interest rate rigidities

In the 1930s the United States prohibited interest on demand deposits and controlled rates on savings deposits. As interest rates in recent

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years moved to high levels those rigidities generated marvellous financial innovation – growth of commercial paper, money market mutual funds, and negotiable orders of withdrawal being major ones. Gradually regulators were driven to face reality, and deregulation has emerged.

But Canada has not had such interest rate rigidities. So it need not have that kind of deregulation, just as it did not need financial innovation to force deregulation in this area.

Interstate banking

Another major reason for financial restructuring in the United States is the restrictions on interstate banking and the ingenious financial innovation in terms of bank holding companies and 'near-bank' banks that they have helped generate. I cannot estimate the time and intellectual energy devoted in US financial institutions to overcoming that rigidity, but it is enormous.

We have no equivalent situation in Canada, since branch banking has existed from early colonial days. Canadians saw branch banking as a valuable asset; the US saw it as a threat. Small wonder that its past regulations and current deregulations differ greatly from our own.

Rigid asset/liability structure of financial institutions:

In the United States the plight of savings and loan institutions is part of current restructuring. Their difficulties arise from interest rate rigidities and from legislatively determined narrow funding bases and a restricted asset base. Restructuring involves them expanding both and becoming more like banks. A similar situation exists in Britain, where the building societies have narrowly focused balance sheets. They will also face a period of adjustment – at the pace permitted by official changes in the law.

There is no equivalent situation in Canada, because legislation has not perpetuated the existence of such institutions. Building societies vanished decades ago. The trust companies were able to develop diversified sources of funds and a diversified asset structure. Even credit unions and caisses populaires have branched out from personal loans into mortgages. In short, among financial intermediaries we do not have the degree of structural problems that exist in Britain and

the United States and so cannot really learn very much from what is going on there.

Trust business

One Canadian curiosity, however, is the separation of banking and trust business. In the late nineteenth century, US trust companies assumed all the powers of banks. The regulators then levelled that playing field by giving banks fiduciary powers – the last deciding legislation being the Federal Reserve Act of 1913.

In Canada the separation of trust powers has been maintained even though trust companies have acquired most of the powers of banks, just as the US trust companies did before the turn of the century.

But I would now like to raise a few issues where our current experiences are somewhat more similar.

RELEVANT US/UK EXPERIENCE

Deposit insurance

Professor Benston has suggested that 'deposit insurance has now become the most important regulatory problem facing the US banking system.' It clearly is also a major issue to be faced in Canada. Both countries face the same questions with respect to it. How much insurance? At what point does deposit insurance lead to market inefficiency rather than efficiency? How does one price deposit insurance? Can one measure the relevant risk to price it? The Wyman Report on deposit insurance will soon be published. At that point these questions will need to be debated in earnest in Canada because it is a key issue. Many other changes in the financial market cannot go forward in advance of its resolution.

New players in the financial system

Both Canada and the United States have seen the emergence of new players who have had a certain flexibility precisely because the regulatory framework did not anticipate them. This has created a distortion in the system between traditionally regulated members of it and the newcomers.

By way of example, in the United States, Sears Roebuck, J.C. Penny, and K Mart are among the big retailers, along with Shearson-

American Express, Merrill Lynch, Prudential-Bache, General Electric, Xerox, American Can, and IT&T – not to mention Citicorp and Bank of America.

In Canada we have Trilon, Power, E-L, Desjardins, Genstar, Laurentian, Traders, Crown, First City, and Principal.

These represent simultaneous developments in the two countries. Therefore, I am not sure what the US development can tell us that we do not already know. At the same time the development leaves us both with major questions to be resolved. These include the following:

1 Does the development mean that there is a demand for a broader range of services than traditional financial institutions have been permitted to provide? If so, then clearly all institutions should be given greater freedom to give Canadians what they want.

2 Are there limits on the concentration of economic power that is in the national interest? Some of the conglomerates are both large and narrowly held.

3 Are there dangers in mixing real and financial activity? This underlies much legislation governing traditional financial intermediaries.

4 Can self-dealing and conflict of interest problems be adequately managed by rules and regulations, or are ownership rules a necessary part of it?

Financial intermediation versus market intermediation

Britain is unique in that it has perpetuated a degree of separation in brokering and jobbing functions that never existed in Canada – not even when the first dealer appeared in 1900. Therefore, all that activity is of little relevance to us. However, the British move toward lifting limits on outside participation in the securities business is of great relevance, as is the Bankers Trust court case concerning whether its commercial paper activity constitutes underwriting – in contravention of Glass-Steagall.

Forcing this issue in North America also is the emergence of securitization of bank loans. If this process goes several steps further, any debate as to whether something is an underwriting or a loan will

begin to resemble a medieval debate on the classification of virtues and sins – all in the eyes of the beholder.

Internationalization

A very common element at work in all three systems is the greatly increased importance of international forces. I believe that this has gone to the point where if domestic law does not accommodate those forces adequately, it will succeed only in creating a distorted and inefficient system.

Another common element is the impact of technology. It is changing ways of distributing services and changing the character of products, combining them differently, and creating new ones. All this tends to make obsolete regulatory structures based on a perception of a world that is fading fast.

As for the effect of internationalization of financial systems, it is pervasive. It is erasing the distinction between domestic and international borrowing and lending, and between domestic and international financial and related services. While most recent Canadian reports on the financial system give lip service to the impact of international forces and international competitiveness, too often their proposals revert to parochialism. The reality of international forces must be fully recognized in financial restructuring.

CONCLUSIONS

1 Much of the restructuring that is going on in the United States and Britain arises from past structures artificially created by legislation and is of little relevance to Canada.

2 Where we face similar restructuring, the process is at about the same stage in all three countries – a case of the blind leading the blind if we count on experiences of the others lighting our way.

3 The most important things we can learn by looking at each other's experiences are:

a) how capricious the perceptions of regulators can be – for example, what is viewed as 'bad' in one country may have been common practice for decades in the others.
b) how strong the forces are for increasing the range of financial services.

c) how overwhelmingly important are the international and technological forces at work.

d) how easily the debate becomes preoccupied with the cases of the individual players and how relatively little attention is paid to the ordinary users of the output of the industry.

FINAL MESSAGE

1 Canada is basically going to have to use its own common sense in introducing change. There is no ready-made model in the United States or Britain.

2 Common sense, in my judgement, means measuring each proposal against the criterion of what it will do for the ordinary user of financial services – not for the people who operate the machinery. I fear that not all the official reports we have seen appear in Canada over the last six months have done this.

Discussion

CHARLES FREEDMAN: I would like to ask Professor Clark a question. He talked about the wave of conglomeration, but he never once mentioned the wave of divestiture in the non-financial industry in the last few years. How does that affect the story, and what is the explanation for that?

ROBERT CLARK: The explanation is complicated, but first let me re-establish the point that you seem to want to challenge. I think the world is irrevocably different from what it was in the mid-1920s – large conglomerate organizations are here to stay, at least for a few decades. There are periods of increased growth and periods of divestitures, which result from all sorts of forces. These forces are important if you are trying to explain a particular movement. I think the basic issue – why there are limits to growth, why everything is not one big conglomerate – is a very poorly developed subject in the economic analysis of organizational forms. I would say nobody really has a good general explanation.

EDWARD KANE: I want to challenge one of the answers you asserted that an economist would give. According to your analysis, an economist would claim that diversification was nothing but a good thing for financial firms and that authorizing additional portfolio opportunities for such firms could only serve to reduce their risk. However, the theorem in portfolio theory that your answer implicitly draws upon is true only for an *infinitesimal* adjustment in the pre-existing portfolio. The adjustments we are talking about in this conference concern potentially very large changes in portfolio allocation that take place in an environment where mispriced deposit insurance systematically subsidizes institutional risk-taking. Given a clear understanding of this difference in premises, a careful economist ought to tell you that he or she would be quite concerned about the increased rate of economic insolvency that could result. The threat of additional insolvencies is a very serious problem, as Mr Neufeld emphasized in his presentation.

ROBERT CLARK: I think diversification per se, at least when done by an institution that previously engaged in a narrow set of activities, does

tend to reduce risks. But I did not mean to deny that a diversified portfolio can be constructed that has a very high risk level, or that deposit insurance may create perverse incentives to construct one.

CHRISTOPHER ROCKER (Chase Manhattan Bank): It seems to me, listening to what we have heard this morning, that regulations and regulators are coming through a reasonably difficult period. Some of the regulation is not viewed as terribly attractive. It seems to me that in the Green Paper that's under discussion, the issues in self-dealing and regulation of self-dealing are really insufficiently addressed. I would like to ask the panel whether it feels that the army of regulators needed to deal with self-dealing and check the nature of activities between institutions would justify or enhance the benefit from instituting a financial holding company and the various subsidiaries that would result.

GEORGE BENSTON: There may be a self-dealing problem for financial institutions. When financial institutions have deposit insurance, a very serious problem is that depositors lose interest in what is being done with their money. Consequently, insiders might be able to use the money for themselves. This is a problem, and it has nothing to do with what powers the financial institutions have. There are so many ways of looting a bank from inside that the real question is what incentives are there not to do so. I am not talking about self-dealing, I am talking about looting. That has always been a problem throughout the history of the commercial world, as far as I know. Prior to regulation, when people were worried about their own money at risk, the deposit-takers had reason to worry that the depositors were worried. They voluntarily put in controls that said if you put your money with us, you won't lose it; therefore, you're more likely to put your money with us than with somebody else. Deposit insurance shifts the risks to the insurance agencies.

EDWARD NEUFELD: I think there is a relationship between internal behaviour and deposit insurance. It will be a challenge for the Canadian authorities to determine the nature of that relationship and then modify the deposit insurance scheme adequately in order to take it into account.

I'm not sure, George, if I understood you correctly, but I think the problem of self-dealing goes beyond that created by the existence of deposit insurance. I can think of so many examples of this in the course of the rationalization of the Canadian banking system over the past century. We started with many banks, and many wound up being absorbed. Very often, self-dealing was an important element in those individual cases, and no deposit insurance existed. Then when you look at the developments of the last three years, individual cases in this country, you wonder whether it was because of deposit insurance, or because of behaviour that arose because of ownership arrangements, or for other reasons.

I do not believe it is all because of deposit insurance. The self-dealing problem is there, and it has to be addressed. The important question is how best to address it. In addition to appropriate deposit insurance arrangements, there is need for balance between regulations on the one hand and ownership rules on the other. There is also the question of whether you should mix real and financial business. Those are the three things I think the regulators are going to have to address. Self-dealing will not be resolved simply by resolving deposit insurance problems.

GEORGE BENSTON: I did not intend to imply that. I am saying that the deposit insurance problem will exacerbate that situation, not that it caused it entirely. But I am concerned that, in order to try to solve the meaningful and real problem of self-dealing, one puts in a set of regulations that costs more to the economy than self-dealing. We should not compare perfection with reality; rather, alternative realities should be considered.

ANDRE RYBA (Economic Council of Canada): I will try to put everybody to work. A comparison has been made in both sessions between the financial sector and the non-financial sector, particularly with respect to regulation. Charles Freedman, for instance, noted one part that is of less concern – the stability of the non-financial sector compared to the stability of the financial sector. I would like to hear the reaction of the various panelists to the concept that the financial sector is based on confidence and this is perhaps why it has been more regulated and why there has been greater concern with the stability of the whole system. I think it was Mr Clark who said that there is no problem

with integration, for instance. Somebody else said that if, for instance, we had a diversified conglomerate, we would be able to regulate each part and alleviate the damage. However, if one part of the conglomerate fails, will that not affect confidence in the whole conglomerate? Again there is some potential problem there.

Consumers may want to have all their services in one place, but they do not want to have all their eggs in the same basket. They will need themselves to diversify or else they may lose confidence when one conglomerate fails.

Again, maybe the panelists can comment on this issue of confidence.

RICHARD BREALEY: This is partly related to the last question. Does one have to regulate these matters, or can one leave it to private enterprise to try and signal quality in some sense? In the real goods market in general, we seem quite happy to leave it to private enterprise. The same problems occur if I am driving in a car across a desert and I see two hamburger joints opposite one another. I don't go to the one called Joe Bloggs' hamburger joint because there is no way that he can guarantee to me that he has a good product, other than by saying 'Your money back if you vomit.' I go to McDonald's, because I know I can get my own back on them if they provide me with a bad product.

Now we have exactly the same sort of phenomenon in the financial markets. One of the reasons I think for the agglomeration is simply that companies are signalling: 'You can get your own back on me, Citibank, or whoever it may be, if I serve you with a dud product, because I cannot afford to lose my reputation.' There are various ways in which companies can signal whether they are good or bad, and they have a very big incentive to signal that way. They will pay Moody's or Standard and Poor's to rate their bonds. They don't leave it to investors, even though the latter would be prepared to make the payment. The company will actually pay to have its bonds rated, because the best companies will have an incentive to say, 'We're not the same as those other people down there.'

There are lots of ways in general that companies can signal whether they are good or bad. You cannot help signalling that you are bad, because the good ones are signalling they are good.

GEORGE BENSTON: One should ask: 'What would happen if people lost confidence in a major bank or set of banks? What would be the result of that for the system?' An individual bank, as Brealey said, has an incentive not to behave in such a way that people would make exessively risky investments. But what can people do with their money when they take it out of a bank? I suggest that if you traced it out you would find that there is no way that the banking system can collapse unless the central bank caused the collapse. People might keep their money in a mattress instead of a bank but the central bank can replace it very cheaply and quickly. Alternatively, people can deposit their money in another bank, and it just recycles. I think that while there will be costs for the banks that collapse, the system is not in any danger. It bothers me very greatly to hear that people are worrying about the US banking system collapsing. While the Federal Reserve can cause or permit such a collapse, individual bank failures cannot produce such a result.

EDWARD NEUFELD: I think Jim Baillie made a very important point when he said the issues go beyond economics – there is the politics of it. In two or three recent failures or at least near-failures in this country, the most sensitive element was the reactions of people who had money in those institutions and their impact on the political process. A political decision was called for in the circumstances. Even from an economic point of view, this is not an issue of minor importance. So when one talks in terms of confidence, stability, and all the rest of it, one is talking not just from the point of view of the smooth functioning of the economic system. The political importance of financial stability is equally crucial.

PART V: RECENT PROPOSALS FOR A NEW REGULATORY REGIMEN

Government responses to the regulatory challenge: the interim report of the Ontario Task Force and the federal Green Paper

James E. Pesando

INTRODUCTION

The Ontario Task Force on Financial Institutions was created in June 1984 by then-minister of Consumer and Commercial Relations, Dr Robert Elgie, in the aftermath of the government's decision to take control of three financially troubled trust companies. The mandate of the Task Force extends well beyond solvency issues per se, to include a general examination of the organization and operation of financial institutions in Ontario. Yet solvency and the related issue of public confidence in the financial system are the central concern of the Interim Report.

The Task Force puts forward four recommendations, the foremost of which is the strengthening of the conflict-of-interest provisions of the Loan and Trust Corporations Act to prohibit self-dealing. Yet the primary objective of the Interim Report is not to make recommendations, but to pose questions and to promote discussion. The Task Force refers to two fundamental goals for the Canadian financial system, solvency and efficiency, and argues that the central task of public policy is to 'balance' the inherent conflict between them. In my review of the Interim Report, I emphasize that, in theory, a deposit insurance system with risk-based premiums can *eliminate* the trade-off between the solvency and efficiency objectives of financial regulation. For this reason, the possible introduction of risk-based deposit insurance merits continued attention, in spite of the predisposition of

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many to view the close regulation of insured institutions as an adequate substitute. The importance of this issue has been highlighted by developments that have occurred since the release of the Interim Report, including the failures of Pioneer Trust and Western Capital Trust and the bailout of the Canadian Commercial Bank.

In its Green Paper, *The Regulation of Canadian Financial Institutions: Proposals for Discussion*, the federal government also highlights the solvency issue. The government chooses, however, to await the report of a private-sector group before making proposals relating to deposit insurance.

Unlike the Interim Report of the Ontario Task Force, the Green Paper does contain major proposals regarding the regulation of Canadian financial institutions. The central proposal is for the formation of a new, federally incorporated financial holding company (FHC). An FHC could own insurance, trust, and mortgage loan companies, an investment dealer (if provincial laws permit), and a newly proposed Schedule C bank. Unlike a Schedule A bank, which must be Canadian and widely held, a Schedule C bank could be closely held by a Canadian FHC. The thrust of this proposal is to allow trust companies and other non-bank institutions to expand into commercial lending, without actually broadening the investment powers of these institutions. Major banks are *not* to be allowed to set up an FHC, and a decision on whether they may be allowed to do so is deferred to the discussions surrounding the 1990 revisions to the Bank Act.

Other highlights of the Green Paper are:

1 Regulation will continue to be by institution, not by function, as each company under the umbrella of an FHC will remain a distinct legal entity and operate under its own regulations.

2 Trust and other non-bank institutions may continue to be closely held, as can Schedule C banks if they are owned by a Canadian FHC.

3 All investors who own, either directly or indirectly, more than 10 per cent of two or more regulated financial institutions, at least one of which is federally incorporated, will be required to set up an FHC, where regulation and supervision to prevent self-dealing and conflict of interest will be strengthened.

4 Investment rules for pension funds and insurance, trust, and mortgage loan companies will be simplified.

In reviewing these proposals, I will draw attention to a number of economic questions that are prompted, but not answered, by the Green Paper.

THE INTERIM REPORT OF THE ONTARIO TASK FORCE

> To the extent that all financial institutions perform the financial intermediation role, should their clients be covered by some form of deposit insurance? (Interim Report, p. 16)

The solvency and efficiency objectives of financial regulation: an overview

The present system of deposit insurance represents a policy response to government concern with the solvency of financial institutions. The system contains an incentive for excessive risk-taking by insured institutions, and this incentive represents a potentially important source of economic inefficiency. Many commentators have noted, for example, how a financially troubled institution might be able to attract deposits by offering a *slight* increase in rates, in spite of a poorly managed or excessively risky asset portfolio. So long as depositors are insured (or act *as if* they are insured), there is no internalization by the market of the economic risks posed by the insured institution.

In theory, a system of *risk-based* deposit insurance can eliminate the most important source of conflict between the solvency and efficiency objectives of financial regulation. As such, the possibility of introducing such a system in Canada merits continued attention, in spite of the predisposition of many to view the close regulation and supervision of insured institutions as an adequate substitute.

I sketch below the economic argument, and then elaborate on certain of its components.

1 If insurance premiums do not internalize the risk of default, deposit insurance provides an incentive for excessive risk-taking by insured institutions. As a consequence, both financial and real capital are likely to be overallocated to risky investments. Further, risk-bearing is likely to be inefficient, as insured institutions lack the incentive to achieve efficient diversification in their asset portfolios.

2 The present system of deposit insurance in Canada is unsatisfactory in light of the facts that insurance premiums are not linked to the probability of a claim, and there exists uncertainty regarding the de facto insurance of deposits in excess of the statutory limit of $60,000. (Implicit insurance premiums, in the form of the additional supervisory and regulatory costs imposed on insured institutions that are experiencing financial difficulty, may be presumed to reflect the risk of default. The importance of this form of risk internalization is not immediately clear.)

3 The conflict between the solvency and the efficiency objectives of financial regulation would be eliminated if deposit insurance premiums were set so as to internalize fully the risk of a claim arising from each insured institution. Consumers would be protected because their deposits would be free of default risk. If an insured institution opted to hold a more risky asset portfolio or to lower its capital-to-asset ratio, within the bounds imposed by regulation, its premium per dollar of insured deposits would rise. The insured institution would thus be forced to internalize the risk of its investment decisions. This is necessary if financial and, ultimately, real capital is to be efficiently allocated.

4 In view of the theoretical attractiveness of a system of risk-based deposit insurance, the CDIC studied carefully the possibility of its introduction. The likelihood that insurance premiums would internalize the risk of default is greatest if these premiums were set by market forces. In spite of the relatively small number of deposit-taking institutions in Canada,[1] the federal government may wish to facilitate the entry of private insurers. At one extreme, the federal government could require deposit-taking institutions under its jurisdiction to purchase insurance from private insurers. The government could then, for a fee, reinsure claims above a certain level. If necessary, the government could use its taxing powers to smooth its underwriting experience over time.

5 Especially if a risk-based system of deposit insurance is not introduced, it is essential that governments *credibly* commit to the legal ceiling on insurable deposits. Only then will uninsured depositors be forced to impose the market discipline ordinarily imposed by subordinated debt-holders. The survey conducted for the Ontario Task Force highlights the importance of this issue, and the more

general need for improved disclosure. The possibility of increasing capital requirements for at least some classes of insured institutions also merits consideration.[2] The objective would be to reduce the actuarial value of claims on the CDIC and to force shareholders to bear a larger portion of the risks taken by these institutions.

6 The goals of (i) protecting consumers and (ii) preventing disruptive runs on deposit-taking institutions motivate government concern with the solvency of financial institutions. Both goals merit critical scrutiny in any discussion of the possible extension of deposit insurance. The second, for example, provides no rationale for extending the equivalent of deposit insurance to institutions where (a) the liabilities are not due on demand *or* (b) the possibility exists for the institution to hold liquid assets equal to 100 per cent of those of its liabilities that are due on demand. The goal of consumer protection can also be invoked too casually. Especially if public consciousness on this issue is raised, the onus will fall upon uninsured institutions to convey credible information to potential customers regarding the security of their claims.

Efficiency considerations and the present system of deposit insurance

If financial and ultimately real capital are to be efficiently allocated among competing uses, then the expected return on real investment opportunities must be commensurate with their risk. The higher the risk, the higher must be the expected return. If deposit insurance premiums do *not* reflect the risk that an insured institution will fail, this efficiency requirement may be violated. An insured institution can raise funds by issuing *risk-free* liabilities, even if the institution invests in very *risky* assets. Without deposit insurance, institutions that elect to hold risky assets would have to pay a premium interest rate on their deposits in order to compensate depositors for their increased risk. With deposit insurance, this need not be the case. Further, insured institutions lack the usual incentive to hold only efficiently diversified portfolios – that is, portfolios that have the minimum degree of risk for a target level of expected return.

In short, deposit insurance may promote both excessive risk-taking and inefficient risk-bearing. A likely consequence is the over-allocation of both financial and real capital to risky investments. This is especially so if all deposits either are or are perceived to be insured.

All federally incorporated banks and trust companies, along with more than 60 provincial institutions, belong to the Canadian Deposit Insurance Corporation (CDIC). Member institutions currently pay premiums equal to three cents for every $100 in insured deposits. In return, their depositors have their accounts legally insured up to a maximum of $60,000. Whether deposits in excess of $60,000 are de facto insured is not at all clear. In a controversial move, the CDIC decided to insure deposits over $60,000 at the three financially troubled trust companies in Ontario, as well as retroactively increasing the maximum insured deposit from $20,000 to $60,000. Just recently, the federal and Saskatchewan governments worked out an arrangement to reimburse not only the uninsured depositors of Pioneer Trust, but also owners of income averaging annuity contracts. As yet, however, no government nor the CDIC has made a commitment to the uninsured depositors of Western Capital Trust. The CDIC, as well as the federal, Alberta, and BC governments and six major banks, participated in the rescue of the Canadian Commercial Bank, thereby ensuring that its depositors suffered no losses on amounts in excess of $60,000.

In short, there exists uncertainty as to whether all deposits – or only those up to the legal maximum of $60,000 – would be insured in the event of insolvency. This uncertainty is likely to promote neither public confidence in the financial system nor a perception of 'fairness' in the treatment of different classes of financial institutions. It is also likely to reduce the discipline one might expect uninsured depositors to impose on deposit-taking institutions.[3]

The insurance premium now set by the CDIC is a constant rate per dollar of insured deposits. There has been no attempt to have an insurance premium that reflects the differential default risk across financial institutions. The resulting cross-subsidies favour high-risk institutions at the expense of low-risk ones. A constant premium per dollar of insured deposits is appropriate if and only if, through regulation, risk is homogenized across institutions. This is obviously not the case at present. Nor is it clear, if such homogenization were feasible, that it would be desirable on efficiency grounds. (An appropriate caveat regarding *implicit* insurance premiums, which may well be risk-based, is developed later in this discussion.)

The ultimate distributional consequences of insurance premiums that do not internalize risk are more complicated. It is inappropriate

to presume, however, that *all* of the benefits flow through to the shareholders of the insured institutions or to those who borrow from them. Competition among insured institutions could result, for example, in depositors receiving interest rates, gross of whatever non-pecuniary services that their deposits provide, that exceed what they could earn on other risk-free assets.

The case for a risk-based system of deposit insurance

If one accepts the economic or political need for deposit insurance,[4] the next question follows immediately. How does one design a system so as to minimally distort the risk-return incentives that are the key to the efficient allocation of financial and real capital? No distortions would arise if the insurance premiums fully internalized the risk of a claim by the insured institutions.

Some may argue that there have been too few failures of financial institutions to permit the design of an experience-based premium structure. Yet option-pricing formulas provide, at least in theory, a means of setting risk-related insurance premiums.[5] Intuitively, the option-pricing formulas confirm that the premium per dollar of insured deposits should be greater, the greater is the variance of the return on the asset portfolio of the insured institution, and the higher is the ratio of insured deposits to the institution's assets.

The argument that one cannot assess the differential risk of institutions that are regulated for solvency is unpersuasive. The ratio of assets to insured deposits does vary across institutions. So does the degree of diversification of asset portfolios. Both of these factors contain information regarding the likelihood of a claim on the CDIC. (Note that the recent troubles of the western-based trust companies have been attributed, in large part, to geographically concentrated investments in real estate.) This is not to suggest that the setting of risk-based premiums would be easy. The extent to which fraud has been an important factor in the bankruptcy of financial institutions is, for example, a complicating factor. Yet to dismiss the argument for risk-based premiums on this account would, in my view, be quite inappropriate.

Implementation of option-pricing models *is* complicated, in part because of the need to quantify the inputs into the option-pricing formulas. However, it should be noted that whenever a non-financial corporation issues debt, the market must assign a value to a like

option. Formally, the market must calculate the present value of the put option owned by the corporation's shareholders (i.e. their ability to 'put' the assets of the firm to its debtholders at the lesser of the face value of the debt or the market value of the assets). The value of this put option is amortized into the yield premium required on risky relative to otherwise identical risk-free debt.

If deposit insurance premiums were set as above, then an insured institution would be forced to internalize the cost of any policies that measurably increased the risk of its insolvency. If the institution opted for more risk in its asset portfolio or for a lower capital-to-asset ratio, within regulatory limits, its insurance premiums would rise.

The introduction of such a system of deposit insurance may be deemed unlikely if deposit insurance is provided by the public sector. A move toward a risk-based premium structure has little precedent. Witness, for example, the deposit insurance provided by the Federal Deposit Insurance Corporation (FDIC) in the United States (although the Garn-St Germain Act of 1982 directed the FDIC to consider a risk-based premium structure). Yet the regulation and supervision offered by the FDIC may provide – at least in part – the equivalent of risk-based insurance premiums.[6] As an insured bank approaches the minimum standard for (say) capital adequacy, the implicit insurance premium – in the form of regulatory or supervisory interference – may increase. If so, the insured bank may be forced to internalize its risk-taking to a far greater extent than that implied by the explicit premium structure. In Canada, each institution insured by the CDIC is inspected on behalf of the CDIC at least once a year. Such inspections have, for example, led to some institutions being required to write down assets and to provide additional equity. Nonetheless, I shall continue with my assumption that any such *implicit* premiums imposed on insured institutions do not fully internalize the risk of default.

In my view, the likelihood that insurance premiums will be risk-based is highest if the private sector is involved in the pricing of deposit insurance. This immediately raises the question of whether private firms could provide deposit insurance. To the extent that insolvency risk has an important systematic or economy-wide component, a private insurer is unlikely to be able to underwrite this risk. (Consider, for example, the analogous situation faced by the Mortgage Insurance Company of Canada, which teeters on the verge of bank-

ruptcy as a consequence of the collapse of western real estate markets, particularly in Alberta.) It is unlikely that the private sector can provide risk-free insurance, or insurance that will be honoured in all states of the world. Yet one would like to exploit market forces to the greatest extent possible in order to price deposit insurance. This suggests the potential attractiveness of a reinsurance scheme. Institutions could be required to purchase insurance, to a prescribed level, from private insurers. The government could then reinsure claims above a certain level for an appropriate fee, and, if necessary, use its taxing powers to smooth its underwriting experience over time. The excess loss reinsurance could be provided on a treaty basis, with the government setting the terms under which it would agree to reinsure.

If private insurers were involved, then market forces would dictate not only the constraints to be imposed on insured institutions, but also the factors that explicitly enter the pricing formula. *If* the fact that an institution is closely held is deemed to signal a higher probability of default, for example, this would presumably be reflected in the insurance premium. In view of the limited size of the Canadian market, it is possible that only one or two firms might enter this industry. As emphasized in the recent academic literature on contestable markets, this does not imply that private insurers would set excessively high premiums and thus earn abnormal profits. So long as there are no barriers to entry or exit, there is no reason for concern on this account.

Recommended changes to the present system if risk-based premiums are deemed to be unfeasible

> Indeed, the existence of deposit insurance seems to substantiate the tacit but widely-held assumption that no financial institution can be allowed to fail in the Canadian context. . . .
>
> In a public opinion survey of Ontario's residents . . . we found confirmation that the public fully expects that government will not allow financial institutions to fail, whether or not they are covered by deposit insurance. (Interim Report, p. 13)

A deposit insurance system with risk-based premiums can, in theory, eliminate the conflict between the solvency and efficiency objectives of financial regulation. For this reason, the feasibility of such a system in the Canadian setting merits serious study. Such an inves-

tigation would, at the very least, provide insights regarding the potential for improved supervisory and regulatory procedures, as well as insights on alternative policies to induce the managers of insured institutions to internalize risk. Until such long-term reform of the deposit insurance system is studied in depth, I would recommend the following:

1 Make *credible* the claim that deposits in excess of the statutory ceiling are *not* insured. Only then will the activities of uninsured depositors, analogous to that of subordinated debtholders, discipline the operation of insured institutions. A necessary condition for this to be the case is for the government to withdraw *explicitly* any *implicit* guarantee that certain financial institutions will not be allowed to fail. Even here, however, market forces would ensure only that interest rates on deposits in excess of the ceiling fully internalized their risk.

2 Do not extend deposit insurance to (say) cash balances held by investment dealers. Attention should be given to the ways in which uninsured institutions could credibly convince their customers of the security of their claims, should public consciousness on this issue be raised.

3 Do not raise the ceiling on insurable deposits above the present level of $60,000.

In addition, I would draw attention to the following:

1 The survey conducted for the Task Force suggests that many individuals do not understand the extent to which their deposits-investments may be at risk in different classes of financial institutions. (It would be even more useful to know what those who have $100,000 in deposits at bank or trust companies view as their downside exposure in the event of the failure of one of these insured institutions.) In general, I would read these survey results to suggest the persuasive case for improved and continuous disclosure, rather than for extended regulation.

2 The capital structure of deposit-taking institutions is heavily weighted toward debt. At year-end 1983, the ratio of shareholders' equity to the total liabilities of the chartered banks equalled 3.82 per

cent. For trust and mortgage loan companies, this ratio equalled 5.07 per cent. An increase in the minimum capital requirement or in the capital-to-asset ratio of insured institutions will, *other things equal*, reduce the probability of insolvency and force management to internalize more of the risk associated with investment decisions. (Note that if an institution's capital base is sufficiently large that it could not be exhausted in even the most adverse state of the world, management would be forced to internalize all of this investment risk.) The adequacy of capital requirements imposed on insured institutions merits scrutiny on this account.

3 If deposit-taking institutions were required to issue subordinated debentures equal to (say) 5 per cent of insured deposits, the holders of these debentures would have the usual market incentive to control risk-taking by management and to price the residual risk into the required interest rate. The former would involve the use of restrictive covenants and monitoring activities. In principle, the combination of higher capital requirements and the creation of a significant class of subordinated debtholders could – through the self-interest of the holders of these claims – force management to internalize the risk associated with its investment activities. To many, this type of reform – which uses the discipline of market forces – may be seen as more practical than a system of risk-based insurance premiums.

4 The externality that justifies the public provision of deposit insurance is the possibility of a costly and disruptive run on a financial institution with highly liquid liabilities but illiquid assets. It provides no rationale for the extension of the concept of deposit insurance to property-casualty or life insurers, or to investment dealers.

5 If there were *no* deposit insurance, the activities of *informed* consumers might ensure that deposit rates internalized the risk of default, even if most consumers were uninformed. If small consumers had a strong preference for risk-free deposits, institutions could respond to this need by (say) segmenting the corresponding deposits and investing them exclusively in Treasury bills. Alternatively, individuals might do this on their own account. These and like possibilities merit note. Deposit insurance did not exist in Canada prior to 1967, and the evolution of the Canadian financial system in the absence of the public provision of such insurance provide the basis for an interesting thought experiment.

Overview: the Financial Holding Company or FHC

The newly proposed FHC sanctions a further blurring of the four pillars of the Canadian financial system: the banking, insurance, trust, and securities industries. Traditionally, the maintenance of the four pillars has been rationalized as a means of reducing the potential for conflict of interest. The Green Paper acknowledges this concern, as well as public concern with self-dealing, and proposes a tighter system of regulation and supervision for FHCs. Self-dealing will be prohibited. However, there will be no requirement that all financial institutions or FHCs be widely held. Conflict of interest will be controlled, in part, by market forces and improved disclosure. A new public body known as the Financial Conflicts of Interest Office will be created, and regulators will be provided with new supervisory powers.

The 'big' question concerning the proposed FHC can be succinctly posed. Do the benefits of the increased flexibility of FHCs to meet consumers' needs justify the increased costs associated with tighter regulation and supervision? (A subsidiary question is whether, in fact, the increased regulation and supervision will succeed in preventing self-dealing and adequately controlling conflict of interest.) Further, do the costs and benefits of this proposal compare favourably to those of possible alternatives? Consider, for example, the apparent concern with the incentive for excessive risk-taking provided by the present system of deposit insurance, which is intensified by the fact that insured institutions can be closely held. Are there alternative policy responses that involve *less*, not more, regulation? What about risk-based deposit insurance together with the requirement that insured institutions be widely held? The Green Paper explicitly rejects the extension of commercial lending powers to the non-banks and proposes the creation of Schedule C banks. Yet what about the alternative of an expanded role for Schedule B banks as a means of achieving the announced goal of improved competition in commercial lending? After reviewing the Green Paper, I do not feel confident that this 'big' question has been adequately addressed.

There are two central questions to be addressed in any analysis of proposed reforms to existing financial regulation. The first is whether the reforms will increase economic efficiency. The second is whether they will have any distributional impact by class of financial insti-

tution. Much of the discussion surrounding the Green Paper has focused on its distributional effect. As I shall argue later, this is not surprising in view of what appears to be the relatively limited *potential* for the proposals to improve economic efficiency. To the extent that the markets for financial services are already 'contestable', so that prices reflect an efficient configuration of costs, even the redistributive impact of the Green Paper is easily overstated.

Improved competition in commercial lending

The goal of improving competition in commercial lending is stated explicitly in the Green Paper. This naturally raises two questions:

1 Is there evidence of 'excess profits' in the commercial lending function?
2 If so, are the proposed Schedule C banks the most efficient way of promoting competition?

There is no evidence presented in the Green Paper to suggest that there is inadequate competition in commercial lending. It would have been useful, if such evidence exists, that it be presented and incorporated into the present debate. It may be useful to note that many commentators, perhaps unknowingly, suggest that this market is *not* competitive. I refer to the oft-repeated observation that the major banks are at present widening the spread between the cost and use of their funds in order to recoup prior loan losses. (In a contestable market, extant banks could not raise their spreads in this manner, and any prior loan losses would have to be absorbed by shareholders.) Such casual observations are not, of course, sufficient to prove that a lack of competition prevails. Indeed, the easing of barriers to entry contained in the 1980 Bank Act revisions, together with the substitute sources of funds available to bank borrowers, might lead many analysts to the opposite *presumption*.

If there is a case for more competition in commercial lending, there remains the question of how best to promote it. Schedule B banks, most of which are wholly-owned foreign bank subsidiaries, invest almost exclusively in commercial loans, yet their growth potential is at present restricted by statute. Allowing Schedule B banks to achieve a larger market share is one way to promote competition in commercial lending. This need not jeopardize any policy objective

with regard to domestic control of the financial system. Yet this option is not discussed in the Green Paper. The alternative of broadening the investment powers of non-banks to include commercial lending *is* explicitly rejected.

In short, I would prefer to see a more careful motivation for the announced goal of promoting competition in commercial lending, together with a careful review of *all* the apparent alternatives to the proposed Schedule C banks.

Competition and efficiency

A stated objective of the Green Paper is to promote competition and efficiency. This objective, in turn, raises two key questions:

1 What regulatory barriers to entry have been removed or reduced?
2 What *additional* economies of scale or scope can now be realized?

The newly proposed Schedule C banks represent the elimination of a regulatory barrier to entry, as closely held non-banks now have a vehicle for entering the commercial lending market. The extent to which this will reduce the cost of commercial loans will, as discussed previously, depend upon the effective degree of competition that currently exists. Foreign owners *can* set up an FHC, but the FHC would not be allowed to own a Schedule C bank. Already, there are no foreign ownership restrictions on the formation of new insurance, trust, and mortgage loan companies.

The claim in the Green Paper is that the FHC will enhance competition among financial institutions, to the benefit of consumers and the overall efficiency of the capital market. However, except for the proposed Schedule C banks, no significant barriers to entry are removed. Thus efficiency gains will occur if and only if the opportunity to exploit existing economies of scale or scope is enhanced. However, the Green Paper refers (p. 23) to academic evidence that suggests that, beyond a certain minimum size, economies of scale or scope are *not* significant in the financial sector. Further, many economies of scope can be realized by *networking*, where one financial institution provides a financial service or contract issued by another. If so, what is the source of the presumed gains in economic efficiency? This question focuses attention, again, on the extent to which the momentum for regulatory change lies more with the interests of extant financial institutions than with the interests of the public at

large. As neatly summarized in the Green Paper (pp. 85-6), the major classes of financial institutions have pressed – both privately and publicly – for their preferred 'shopping lists' of regulatory reforms.

Closely held versus widely held financial institutions

An investor or an associated group of investors may not own more than 10 per cent of the shares of a Schedule A bank. The major banks have argued that this ownership restriction should be applied to all deposit-taking institutions, with existing closely held institutions having a ten-year 'grace' period to comply with the restriction. The Green Paper explicitly rejects the banks' proposal. If there were no regulatory distortions, received economic analysis would provide no basis for requiring that financial institutions be widely held. Because of the incentives to excessive risk-taking contained in the present system of deposit insurance, received economic analysis may provide such a rationale. I sketch the relevant argument below.

For simplicity, consider a corporation that has only two types of claims, common shares and debt. An important insight provided by modern finance theory is that one can view the capital structure of this firm as follows. The debtholders are the owners of the corporation's real assets but have sold a call option written on these assets to the shareholders. The striking price of this call option is the book value of the corporation's debt. Viewing the capital structure in this manner highlights the potential conflict between the holders of these two classes of claims to the corporation's real assets. Other things equal, for example, shareholders prefer to engage in riskier undertakings. If the undertaking proves very profitable, then the shareholders pay off the debt-holders and retain the surplus for themselves. If the undertaking proves unprofitable, then it is the debt-holders – who do not participate on the upside – who may find the corporation's real assets worth far less than the book value of their claims.

How is the above conflict resolved by the marketplace? First, the yield required by the debt-holders will be commensurate with their perception of the risk associated with their claim on the corporation's real assets. Second, to control this risk, restrictive covenants are likely to be used by debtholders to restrict management's freedom to act against their interest. Debt covenants often include, for example, restrictions on management's right to issue new debt, to pay

dividends, to engage in merger activity, and to dispose of assets. The use of restrictive covenants to protect the interests of debt-holders, together with the differential degree of risk nonetheless assigned by the market to the debt of different firms, is well known and an integral feature of the capital market.

The key to the present argument is the standard agency problem that exists for the shareholders of a public corporation. This is best seen by considering first a firm in which there is a single owner-manager (OM). The OM will take every action to increase his own wealth, which is economically efficient. However, if the OM issues external equity, he will take advantage of opportunities to increase his wealth at the expense of the new shareholders. The OM may do this, for example, by taking 'perks' in a variety of forms. The OM is the agent of the new shareholders, yet has personal incentives which may conflict with their interests. To solve this agency problem, new shareholders must incur monitoring costs of one form or another to reduce the scope of the OM to act against their interest. This agency problem is of a quite general nature. If the OM issues debt, then bondholders face an analogous problem. The restrictive covenants cited earlier represent the market solution to the agency problem faced by debtholders, whose objective is to limit management's ability to act against their interest. In this case, the agency problem faced by the shareholders of the insured institution may work to the advantage of the CDIC and contribute to economic efficiency. Managers, concerned by the implications of insolvency for their own positions, may pursue less risky investment strategies than is in the interest of the institution's shareholders. Included in managers' 'perverse' incentives is the desire to avoid self-dealing should this adversely affect the prospects for the solvency of the institution. In short, managers in a widely held institution are likely to opt for less risk than would an owner-manager in a situation where an owner-manager has a strong incentive to take more than the socially optimal amount of risk.

There would be no persuasive case for requiring deposit-taking institutions to be widely held in the absence of the incentives created by the present system of deposit insurance. If a risk-based system of deposit insurance were introduced (a system that might well have higher premiums, other things equal, for closely held institutions), the argument for requiring insured institutions to be widely held would be pre-empted. Under the present system of deposit insurance,

economists' general predisposition to favour closely held firms loses much of its appeal.

Consumer protection plan

In addition to citing the issues raised in the present debate regarding deposit insurance, the Green Paper raises the possibility of introducing insurance for policyholders of life and property-casualty companies. It is suggested that such a program might 'have a generally similar structure and be based on generally similar principles' as deposit insurance (p. 47).

I have stated the strong economic case for a system of risk-based deposit insurance in my discussion of the Interim Report of the Ontario Task Force. I would emphasize that the case for extending the insurance concept to policyholders is far weaker than for deposit-taking institutions. For policyholders, the issue is exclusively one of consumer protection. Those who would advocate the extension of the insurance concept start with the presumption that the small policyholder is either unwilling or unable to assess the solvency of the institution with which he or she deals. They might also point to the fact that four property and casualty insurers *have* failed since 1981.

In arguing against the extension of the insurance concept, I would emphasize the following:

1 If public consciousness on this issue is raised, it will behove insurance companies to convey credibly to their potential customers the fact that their claims will be honoured. Just as travel agencies will advertise that they have posted bonds to ensure their performance, life and property-casualty insurers will find analogous ways of committing themselves to performance and so communicating this fact to the public.

2 If paternalism in the form of consumer protection is used to justify the *public* provision of insurance for policyholders, it is not clear where to truncate this concern. Should the claims of small consumers against any institution or corporation that is subject to regulation be guaranteed by the government?

3 If the government requires the affected institutions to set up their own guarantee fund, the institutions would have an obvious incentive to self-police. In theory, and if the regulations so permitted, the

activities of such institutions could internalize risk in the same manner as risk-based insurance premiums. The danger here, of course, is that any such powers might be used by the association to deter entry.

In short, I think it would be far preferable to convey to the general public – in a nonalarmist way – that its policies may *not* be honoured if an insurance company goes bankrupt. This, in turn, should raise public consciousness and create an incentive for the insurance companies to commit credibly to being able to fully honour their claims.

Simplification of investment rules

The Green Paper proposes to eliminate the quality tests (requiring, for example, that equities meet certain earnings and dividend tests) that are contained in the present investment rules of insurance, trust, and mortgage loan companies. The elimination of these quality tests can only improve the risk-return trade-off faced by these fund managers. Their elimination may also improve the terms at which small and medium-sized firms gain access to debt and/or equity capital.

The Green Paper proposes that the quality tests be replaced by general quantitative rules on portfolio composition 'to ensure diversification.' The goal of improved diversification is linked to the concern with the solvency of financial institutions. In my view, the importance of this issue cannot be overemphasized, and it extends well beyond the specific issues raised in this section of the Green Paper. Much of the financial difficulties facing western trust and mortgage loan companies can be traced to geographically concentrated investments in real estate. In part, the absence of an incentive to hold a more diversified portfolio is tied to the present system of deposit insurance. In any discussion of the design or extension of deposit insurance, note should be made of the need to provide incentives for efficient diversification. At present, for example, the assets of credit unions and caisses populaires are concentrated in nondiversified portfolios of real estate and personal loans. This makes them vulnerable to local or idiosyncratic shocks that, in principle, could be eliminated if these institutions held well-diversified portfolios.

Finally, the Green Paper suggests that a more general 'prudent portfolio' approach merits consideration for trusteed and life insurance pension funds. I take this as an opportunity to argue for a

further change – that of raising the percentage of their assets that pension funds can invest in foreign securities.

Under current provisions of the Income Tax Act, registered pension plans in Canada must restrict their holdings of foreign securities to 10 per cent of their assets or face severe tax penalties. Because of opportunities for efficient diversification, the risk-return trade-off facing pension fund managers would improve if this requirement were relaxed. Fund managers would be able to earn a higher expected return for a given amount of risk, or, equally, to bear a smaller amount of risk in order to earn a given expected return. Only if the exchange-adjusted return on a diversified portfolio of foreign stocks is perfectly correlated with the return on the market portfolio of Canadian stocks will no such improvement in the risk-return trade-off occur. Such a possibility is quite remote. Indeed, preliminary evidence suggests that the potential advantages may be quantitatively quite important.[7]

The standard argument against the removal of this restriction is that it would occasion a sufficiently large rechanelling of domestic saving to foreign securities so as to raise the cost of debt and/or equity capital to Canadian firms. In turn, it is argued, this will reduce the level of real capital formation in Canada.[8]

In my view, the above concern is easily overstated. Because of the mobility of international capital flows, any redirection of Canadian savings abroad is likely to be offset by a corresponding increase in foreign saving available to Canadian firms. The increase – if any – in the cost of debt or equity capital faced by Canadian firms will be severely curtailed by the inflow of capital from abroad as well as by the realignment of domestic saving held outside pension funds.

NOTES

1 As of 31 December 1984, as reported in the Green Paper, there were 72 chartered banks and 133 trust and mortgage loan companies (59 CDIC-insured federal, 63 CDIC-insured provincial, and 11 non-CDIC-insured provincial). In addition, there were 1,781 credit unions and caisses populaires outside Quebec, and 1,419 locals in Quebec. These figures suggest that the market for private deposit insurers would be far greater if they participated in the insuring of these latter institutions.

2 As emphasized in the paper prepared for this conference by Edward J. Kane, these capital requirements would be meaningful only if assets were valued at their market, not their book, levels.

3 In principle, one might look for evidence on this issue by examining the differential in the deposit rates paid on deposits above or below the $60,000 cutoff, especially across institutions with *a priori* differences in their likelihood of default.

4 A careful analysis of the different rationales for the provision of deposit insurance can provide useful insights into both its design and its possible extension. I intend to pursue this issue in a more detailed report to be prepared for the Ontario Economic Council.

5 See, for example, Alan J. Marcus and Israel Shaked (1984) 'The valuation of FDIC insurance using option-pricing estimates', *Journal of Money, Credit and Banking* 16(4) (November) 446-60. Note that insured depositors hold a put option to reflect their ability to 'put' their deposits at a failed institution to the insurer at the lesser of their face value or the value of the supporting assets.

6 See Stephen A. Buser, Andrew H. Chen, and Edward J. Kane (1981) 'Federal deposit insurance, regulatory policy, and optimal bank capital,' *Journal of Finance* 35(1) (March) 51-60.

7 See Nicholas A. Michas (1984) 'Pensions funds: more diversification'. *Canadian Public Policy* 10(1) (March). Michas's results, which only should be viewed as illustrative, suggest gains of the following order of magnitude. If the fund manager can hold *only* Canadian stocks, the efficiently diversified portfolio with an expected return of 21.5 per cent has a standard deviation (the conventional measure of risk) of 31 per cent. If the fund manager can hold up to 10 per cent of his equity portfolio in foreign stocks, the efficiently diversified portfolio with this same expected return has a smaller standard deviation of about 28 per cent. If there were no limit on the size of the foreign holdings, the efficient portfolio with this same expected return would have a standard deviation of only 22.3 per cent. For a fund manager seeking this target rate of return on his equity portfolio, removal of the 10 per cent ceiling would allow him to reduce his risk by 20 per cent, as the standard deviation would fall from 28 per cent to 22.3 per cent.

8 After I had completed this paper, the new federal budget proposed that pension funds be allowed to place $3 into a foreign investment for every $1 placed in a new program for investing in a Canadian

small business. In theory, this could allow a pension fund to invest an additional 21 per cent of its assets in foreign securities, given the 7 per cent upper limit (in effect) on these small business investments. For the reasons cited in the text, this initiative is an attractive one.

Discussion

CHARLES SLATER: This discussion should include some mention at least of a sometimes-criticized, often-overlooked institution that seems to work quite well. It is the National Contingency Fund, operated by securities dealers through their self-regulatory organizations. The key to its success may be not the dollar amount of insurance – the fund's $8½ million wouldn't go very far these days – but rather the dealers' collective commitment to make good on the defaults of a member that gets off-side. And most important, the self-regulatory activities of the participating organizations reinforce that commitment.

COMMENT FROM THE FLOOR: I might say the fund is really great as long as there are no failures.

J. PEARCE BUNTING: It is an interesting question, and obviously what you say is correct, that the possibility of default always exists. But one of the interesting things that I might speak to, as Professor Pesando was saying, is that there is a front-end hit. You hit every one of the responsible institutions – the Vancouver, Montreal, and Toronto stock exchanges and the IDA – if they have not done their regulatory job. Then you go to the fund. In addition, the fund is small because I don't think there is anybody alive who has lost money with a dealer. Obviously, you can lose money in dealing with brokers, but you do not lose your money because the dealers become insolvent.

The brokers want to maintain that tradition, and they know that in order to do it there can be a very heavy hit on them. They are willing to have the institutions do an excellent regulatory job as far as they are concerned. So up front you have the hit on the institution that is worried about having a heavy financial commitment, and behind that you have the dealers who are worried about the fact that they could be hit. I wonder whether it might not really be better for the pressure to be there than, let us say, on the shareholders, who really do not have a lot to do with whether or not that happens.

GEORGE LERMER: My comment will not be concerned with Alberta securities regulation. I would like just to comment on one point that Professor Pesando made in his paper, about the trade-off between

deposit insurance with variable rates – that is risk-related rates – and constraints on ownership. My only concern is that he looked at the agency problem in a static context, namely the managers' and the owners' normal conflicts of interest. One of the main concerns of the efficiency and regulation study for the Economic Council of Canada had to do with an entrepreneur's opportunity to capitalize the results of his entry and effort. In a world where nationalism limits entry across the border, and regulation limits entry between pillars, the ownership consideration is paramount since it affects the willingness of entrepreneurs to enter the industry, and I am not sure if that point was captured in the paper.

STEVE BROWNE: One certainly can fully back the notion of risk-related deposit insurance. What seems to be coming is policy-holder insurance, or a variation on that theme. I would have to dissent from the notion that you cannot assess risk and therefore that this system cannot work. You can quickly get into a logical inconsistency, because the basis of regulation is that you can assess risk on the basis of information that is provided to the regulators. If you believe that the business of regulators is to assess the likelihood of insolvency or financial difficulty, then presumably we can make risk assessments. If that is the premise, then why not use that assessment of risk to set insurance rates? That should be possible to do, at no increase in reporting burden. The person who is setting the insurance rate should be able to make those judgements on the same information base that the regulators have at their disposal to assess the basic solvency of an institution.

The second point, about the positive information returning from the institutions to the marketplace, I would support. Sun Life Assurance has one of the least-leveraged balance sheets around, and our sales force uses that point. It does have an effect, especially in our operations in the United States. It is less of an issue I think in Canada, but certainly that process of making people aware of the financial underpinnings of the firm does help in differentiating your product in the marketplace.

A final comment on the risk-related aspects, and the moral hazard issue. You can look at property insurance in Canada and recognize that major advances in worker safety, fire regulation, and so on did not come through the regulatory process, or through the fire marshal's

office in the first instance. They were brought about through the process of internalizing risk through insurance premiums, on-site inspections by the insurers, and so on. Why should those principles have to be suspended when we move out of the industrial sector into the financial sector?

ED LAUZON: Professor Pesando, in your argument on the concentration of ownership, you referred to one particular result from the agency literature. Recently, we have seen information and agency results that do not necessarily have the same implications – that 100 per cent ownership by an entrepreneur is necessary. For instance, in one construct a very high percentage of the manager's personal wealth is tied up in the enterprise, but it may be a very small percentage of the equity in the organization. This gives the same signal to the market as if he held the firm entirely. With a large percentage of the manager's wealth invested in the firm producing results similar to the manager owning a large percentage of the firm, I am reluctant to rely solely on any specific agency model.

JIM PESANDO: I take the essence of the first comment to be that perhaps a self-regulated industry with a guaranteed fund would internalize risk in a manner not too dissimilar to, say, a system of risk-based deposit insurance. One concern stems from recent experience in Maryland and Ohio where runs occurred on privately insured thrift institutions. This raises the obvious question of whether risk-free guarantees could be provided by a self-regulated insurance fund.

One would also want to be very careful that such a self-regulating fund did not become a means of creating barriers to entry rather than of internalizing risk. Nonetheless, the notion that we try to get the private sector involved in the pricing and delivery of insurance, once it has been established that there is a market demand for that insurance, is very attractive.

I now turn to the second comment on deposit insurance. Some have argued that an important objective of introducing deposit insurance in 1967 was to eliminate a potential barrier to entry into the deposit-taking industry. Let me note in reply that a system of *risk-based* deposit insurance, or an alternative way of internalizing risk, may be used to achieve the desired result. The desired result, of course, is that new entrants are not inappropriately penalized by a public that

assigns to them a higher risk status than economic fundamentals warrant.

Concerning the third comment, just let me emphasize that the academic literature has well established the virtues of risk-based insurance premiums. Practitioners, however, point to the difficulty in implementing risk-based premiums. In my prior remarks I tried to acknowledge the legitimate concerns regarding implementation. Yet, to keep this concern in perspective, it is useful to note one simple point. Every day, market participants price risky relative to risk-free debt. Yet this is a completely analogous problem to that of setting risk-based insurance premiums.

For the record, I am *not* one who would argue that these practical obstacles pre-empt the case for a closer look at risk-based premiums. Finally, as an academic point, the owner-managed firm is efficient. There is no agency problem by definition, since the owner and the manager are one and the same. Whenever you do not have an owner-managed firm, you do have an agency problem, as well as an attempt by the market to solve it. In the case that you suggest, a manager has a lot of his personal wealth invested in the firm, even though it is a relatively small fraction of the total wealth of the firm. In this case, the concern would be that the manager might not take *enough* risk, from the point of view of maximizing shareholders' wealth.

PART VI: DEREGULATION: GOALS, APPROACHES, AND CONSEQUENCES

Economic prerequisites to the deregulation of financial institutions

John F. Chant

Many changes have been made to the regulatory framework governing financial institutions in Canada over the past two decades. The Bank Act of 1967 rid the financial sector of regulated interest rates, though in the Canadian case the instrument of regulation was the power of the Canadian Bankers' Association to set the deposit rates of the chartered banks. It also extended the ability of the chartered banks to hold residential mortgages. At the same time, the Canada Deposit Insurance Corporation was established. Similarly, the 1980 Bank Act permitted chartered banks to offer leasing and factoring services, established a framework to govern activities of foreign banks in Canada, and shifted the operation of the cheque clearing system from the Canadian Bankers' Association to the newly created Canadian Payments Association, providing access on an equal basis to all deposit institutions.

The activities carried on by different financial institutions have also changed remarkably over the past two decades. The general purpose payment card was first introduced by the chartered banks but is now offered by every type of deposit institution. New financial instruments and new variants of existing instruments have emerged throughout the period. Deposit accounts now offer many options with respect to minimum balances, service charges, and the payment of interest. A similar variety of mortgage options can also be found. Finally, the services offered by each type of financial institution have also altered substantially. Chartered banks, for example, now offer their customers access to brokerage and trustee activities. Although

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the present purpose is not to identify the sources of these changes, technological change and the response to continuing inflation and high interest rates must rank high as contributory factors.

Changes in the legal framework that governs the financial system have had only a limited effect on these developments. While the chartered banks have seen their powers extended into leasing, factoring, and the residential mortgage market, the establishment of the Canadian Payments System is the primary policy change which extended the powers of other financial institutions.[1] The ten year term of the Bank Act has precipitated its review prior to the revisions of 1967 and 1980, but federal laws governing trust companies have remained essentially unchanged for over fifty years.

The title of this paper deserves some explanation. It implies that some set of economic conditions must be met before deregulation of financial institutions can proceed. To an extent this impression is appropriate. A central theme of this paper concerns the desiderata that should be kept in mind through any revision to the regulation of our financial system. The purpose of the paper is to explore the ways or the degree to which the apparently conflicting goals of depositor safety and economic efficiency can be achieved through deregulation of the financial system.

Two calls for deregulation

A call for deregulation, its title aside, is not a new phenomenon in Canadian financial markets. The reports of both the Porter Commission in 1964 and the Economic Council of Canada in 1976 can be interpreted as strong calls for the deregulation of the financial sector. The Porter Commission recommended:

> that the Bank Act be extended to cover a wide group of institutions which are now engaged in the business of banking, that those not coming under the legislation be prohibited from undertaking this business and that a broader range of lending powers be granted to all lending institutions. . . . our recommendations would permit the savings banks and the trust, loan and other companies coming under the banking legislation to compete for commercial and personal lending business. (Canada 1964, p. 563)

The Economic Council, seeming to echo the Porter Commission, recommended:

> that the federal and provincial governments adopt an approach to the regulation of deposit institutions whereby the rules governing an institution should relate to the activities or functions undertaken by that institution. Deposit institutions would include all institutions offering liabilities of fixed money value that can be cashed in demand or on short notice, or that can be transferred to other parties by payment order. (Economic Council of Canada 1976, p. 132)

Adoption of this 'functional' approach to deregulation, the Economic Council argued, would have represented a major step toward deregulation of financial markets.

> The functional approach involves the regulation of activities of deposit institutions on a function-by-function basis. Instead of restricting particular financial institutions to particular functions, all deposit institutions would be allowed to undertake similar functions, provided they met the regulatory requirements established for each function. New institutions would be able to choose the combination that they could perform most efficiently and competitively with existing institutions. (Economic Council of Canada 1976, p. 60)

The next section will evaluate the obstacles which have derailed these and other moves towards deregulation. The thesis of this paper maintains that these obstacles are less important than the need to achieve a proper balance between market regulation and prudential regulation. Therefore, having dealt with the obstacles, the focus in the subsequent section will turn to the alternative approaches to regulation, and finally to some prerequisites and priorities to keep in mind in exercising a choice.

OBSTACLES TO DEREGULATION

Deregulation in Canada has preceded deregulation in the United States in many dimensions, especially in the control of interest rates. On the other hand, despite the strong recommendations of two advisory groups, little has been done to enhance the competitiveness

of financial markets by expanding the powers of financial institutions other than chartered banks. In order to understand the possible outcome of current pressures for deregulation, it is useful to examine and evaluate the obstacles that have prevented reform of regulation in the past. These obstacles include i) the division of powers between federal and provincial governments, and ii) the 'four pillars' approach to the assignment of functions among participants in financial markets.

The division of powers between federal and provincial governments

The major financial institutions in Canada operate under distinctly different sets of regulations and, just as important, under the jurisdiction of different levels of government. The British North America Act assigned responsibility for currency and coinage and for banking in general to the federal government. As a consequence, the major responsibility for regulating the chartered banks rests with the federal government and is performed by the Inspector General of Banks. Trust and mortgage loan companies can be incorporated under either federal or provincial jurisdiction, but must obtain a licence from provincial authorities in order to operate in most provinces, regardless of their place of incorporation. Finally, the centrals and locals of credit unions and caisses populaires are both incorporated provincially and operate only within the province of their incorporation.

The lines of responsibility are complicated by the fact that agencies of some levels of government exert their authority over institutions which are primarily the responsibility of other levels of government. The Canada Deposit Insurance Corporation (CDIC), for example, insures deposits of provincially incorporated trust and mortgage loan companies which have most other aspects of their business governed by provincial authorities. Financial institutions that are provincially incorporated must be in substantial conformity with federal legislation governing similar institutions in order to qualify for coverage under deposit insurance. Similarly, the Quebec Deposit Insurance Board (QDIB) insures all deposits of trust and mortgage loan companies held in Quebec, regardless of the incorporation of the institution.

The recent hearings with respect to the application of the Toronto-Dominion Bank to offer Green-Line investment services to investors provides another example where the lines of responsibility become

complicated. Toronto-Dominion is federally incorporated as a chartered bank, whereas the activity of supplying investment services falls under the authority of the Ontario Securities Commission.

These instances of overlapping responsibility differ with respect to the degree of harmony under current arrangements. For example, at the time of the introduction of deposit insurance in 1967, the division of responsibility between CDIC and QDIB appears to have been reached easily, to the degree that CDIC provides QDIB with a line of credit. In other circumstances, conflict seems more likely between federal and provincial authorities or among provincial authorities.[2] The exercise of provincial authority over the activities of a federally-incorporated bank in the Green-Line case may not have been accepted so easily had the decision been against the bank.

The prospect of federal-provincial conflict appears to have deterred the implementation of the calls for deregulation. The Porter Commission recommended that the definition of banking be expanded to include:

> the present chartered and savings banks, many trust and loan companies, some other deposit-taking institutions and such sales finance companies as issue banking claims not exempted by the legislation

and, more significantly, that:

> federal regulation and supervision should apply to all institutions deemed to be banking institutions, and that all institutions not chartered or licensed by the authorities should not be permitted to engage in banking activities. (Canada 1964, p. 363)

Similarly, the 1976 White Paper on banking legislation made a set of recommendations which would have required many provincial institutions to meet federally imposed reserve requirements. First, the White Paper proposed:

> all institutions in Canada accepting deposits transferable by order will be required to join the [Canadian Payments] Association. Local credit unions and caisses populaires offering chequing facilities will be required to be members of a central

> or similar body which will belong to the Association. (Canada 1976, p. 18)

In addition, it suggested legislation:

> to require minimum reserves in the form of Bank of Canada notes and deposits against all demand deposits, all time deposits with an original term to maturity of one year or less, and all time deposits having an original term to maturity in excess of one year that are in practice uncashable on demand . . . The requirements will be met by all members of the payments association. (Canada 1976, p. 20)

Neither the proposals of the White Paper nor of the Porter Commission were followed through. In the case of the White Paper, the recommendations were dropped in the face of strong opposition from the provinces, especially Quebec.

More recently, another form of jurisdictional conflict has emerged with respect to the regulation of Canadian financial institutions. While provinces have historically maintained roughly similar regulations with respect to financial institutions that operate beyond provincial boundaries, the situation has changed substantially with the passage of Bill 75 by the Quebec government. This bill:

> authorizes Quebec chartered insurance companies to engage in a number of non-insurance activities without the prior approval of the responsible minister. In addition, with ministerial approval, it provides them the opportunity to conduct virtually any kind of financial intermediation. Furthermore the Quebec government has announced its intention to proceed in a similar vein with changes in its legislation governing trust companies and caisses populaires, thereby producing a *de jure* elimination of the current boundaries between financial intermediaries operating within that jurisdiction. (Ontario 1984, p. 3)

This initiative is judged by the Ontario Task Force on Financial Institutions to be a threat to its regulatory goals. It recommends that:

> The Government of Ontario request 120 days notice in writing from any insurance company wishing to pursue corporate

> activities which deviate from those allowed by the Insurance Act of Ontario. (Ontario 1984, p. 27)

The Quebec initiative clearly alters its approach to regulation to such a degree that a co-ordinated approach by the provinces to the reform of regulation of financial regulations may be difficult to achieve. Moreover, the reaction of other provincial authorities may add difficulties to maintaining a national financial system.

The present devolution of responsibility for regulation of financial institutions appears to work reasonably well in avoiding conflict between different levels of government. The system now appears to be facing more substantial pressures than in the past, however, not the least of which is the pursuit by one provincial government of an independent and different approach. But the desire of most authorities to maintain fundamentally similar regulation to assure a national financial system does not bode well for any change in approach to regulation. The need to gain the acceptance of the various regulatory authorities serves as a fundamental obstacle to deregulation.

The four pillars concept

A further obstacle to deregulation is the four pillars principle which distinguishes banking, trust activity, insurance, and investment dealing as separate types of financial activity. The concept is based on the argument that there are key activities within each pillar which would suffer in combination with activities which are properly part of another pillar.

Two questions need to be answered about the four pillars concept. First, why must the key functions of each pillar be kept separate? Second, how descriptive is the four pillars concept of either the development or the present state of the Canadian financial system? Accordingly, a discussion of conflicts of interest and concentration of power in financial institutions will address the first question, followed by an evaluation of the actual distinctiveness of the four pillars as they exist today.

Conflict of interest

Fear of conflict of interest appears to be a major motivation behind the four pillars concept. Certain types of financial activity apparently

should not be carried on within the same financial institution because they are inherently incompatible. It is argued that the customers for one of the services, or possibly both, would be better served if the services were supplied separately by different institutions.

A review of the reasoning with respect to the possible conflict between commercial banking and trust activity can illustrate this issue more fully. Trust companies hold the portfolios of customers through their estate, trust, and agency activities and can make decisions with respect to the placement of these funds among competing investment opportunities. In this capacity, the trustee is investing on behalf of its client. In contrast, a bank as a commercial lender supplies funds on its own behalf to borrowers – possibly the same borrowers that receive the funds invested by the trustee on behalf of its customers.

The combination of the investment function of the trustee together with the commercial lending function within a single institution supposedly places that institution in the compromising position of having to trade the interests of customers against its own interest as an investor. The conflict becomes particularly clear, for example, when unfavourable information becomes available regarding the prospects of a company that borrows from the bank and has other outstanding securities held by the trustee on behalf of the bank's clients.

The value of the securities held by the trustee may in some circumstances depend on the decision taken by the bank to foreclose. In the absence of foreclosure, the probability will be greater of the firm surviving and meeting its obligations to creditors other than the bank. On the other hand, foreclosure may protect the interests of the bank as a commercial lender. Clearly, the banker-trustee cannot protect both interests simultaneously.

This case for the separation of commercial lending and trustee activities depends on several implicit arguments. First, it may be assumed that the particular alignment of the four pillars separates activities that are incompatible by nature. Yet the demonstration of a conflict of interest is not sufficient in itself to require that the combination of activities leading to that conflict be prevented. Conflicts of interest are ubiquitous in financial market activity. One of the most comprehensive studies of conflict of interest in financial markets began with the general observation:

> We are, to paraphrase Chesterton, all conflicted now. Anyone who is at all active in our society is confronted by conflicts of some sort. (Twentieth Century Fund 1980, p. xiii)

Commercial banks themselves, just in the activity of lending, even without participating in trust activities, may be drawn into circumstances where the interests of one customer conflict directly with the interests of another. For example, one customer may request bank credit precisely for the purpose of financing an unfriendly takeover of another customer. Alternatively, a borrower from a bank with emerging financial problems may also be a borrower through trade credit from another customer of the bank.

The other side of the commercial bank-trustee conflict – the trust companies – also faces inherent conflicts of interest within its own activities. Just like the banks, a trust company may administer accounts of clients who hold different types of securities issued by the same firm so that the trust company's actions may affect the welfare of the two customers in very different degrees. One action may be preferable from the standpoint of one customer while another is preferable for the interests of the other.

As the earlier quotation from the Twentieth Century Fund suggests, conflicts of interest are unavoidable in almost any type of financial activity. A look at existing conflicts shows that some conflicts appear acceptable, whereas others appear so substantial as to shape the regulatory approach to financial institutions.

The next assumption implicit in the conflict of interest argument for the four pillars may be that the conflicts which already exist must be less important, and even different in kind, than the conflicts which would arise from the combination of activities which are now part of separate pillars. This assumption suggests that the present conflicts across financial activities can be resolved only by keeping the activities separate.

Yet separation is not the only approach for dealing with conflicts. They can also be dealt with by other measures 'to prevent abuse, to limit its harmfulness, or to facilitate redress' (Mayer 1980, p. 433). Measures to prevent abuse or to reduce harm involve the formulation of rules of conduct for agents who face conflicts; measures to facilitate redress include the establishment of liability rules in circumstances where agents abuse their trust. In some circumstances, it may be appropriate not to interfere at all. The agents' clients may be harmed

by preventive or remedial steps to a greater degree than by the conflict itself.

But the assumption of the relative unimportance of existing conflicts still suggests a strict division of policy. The present conflicts within pillars are apparently amenable to treatment through measures other than separation of the activities whereas the conflicts arising from the combination of activities now in different pillars are best dealt with through separation.

The Twentieth Century Fund study *Abuse on Wall Street* (1980) provides a comprehensive examination of the conflicts of interest inherent in the workings of the American financial system. In a study of the working of commercial bank trust departments that formed part of this larger study, E.S. Herman argues that:

> legally enforced total separation of trust and commercial banking could not now be based on the level of present abuses and anticipated benefits to consumers of trust or commercial banking services. (Herman 1975, p. 126)

No such study has been undertaken for Canada, even though the Economic Council (1976) recommended:

> that a careful examination of the fiduciary activities of trust companies be carried out immediately, particularly with regard to the conflict of interest between intermediary and fiduciary activities. (Economic Council of Canada 1976,p. 133)

Such a study could provide some of the evidence which would be necessary for judging the validity of the conflict of interest rationale for the four pillars approach.

Concentration of power

A second rationale for the four pillars approach concerns the question of concentration of power. The Department of Finance suggests that the concentration issue involves two separate dimensions:

> One of the chief concerns raised in the discussion of regulatory change in the Canadian financial system is the possibility that relaxing inter-industry barriers might increase competition only in the short run while ultimately leading to the demise or

absorption of smaller institutions and thus to a more concentrated, less competitive system in the long run. (Canada, January 1984b, p. 5)

and:

> There is an additional set of issues arising from the potential for social and political power to derive from the concentration of economic power. For example, concentration of economic activity in the hands of a few firms places the owners and executives of these firms in a position to exert influence over policy and public opinion. (Canada, March 1984, p. 2)

Similar concerns were expressed to the Ontario Securities Commission in its hearings with respect to the Green-Line investment service:

> One principle that was advocated in the course of the meeting but which we had difficulty accepting involves the relative economic power of the participants in the various segments. Much was made of the economic power of the banks which, it was asserted, would enable them to displace the securities dealers initially from the discount brokerage business and ultimately from the securities business altogether. (Ontario 1983b, p. 697)

The Commission's grounds for rejection of the argument are of interest:

> [S]ize does not necessarily translate into dominance, particularly in a service industry where bureaucracy of size may be a hindrance. In addition, the banks, regardless of their size, must like all participants in the capital markets, abide by applicable laws and policies. We believe that the existing laws are such and the powers of the Commission are such that the segregation of the investment banking and commercial banking segments of our financial system can be preserved and that the effects of the domino theory will not materialize. (Ontario 1983b, p. 70)

This double-barrelled dismissal of the concentration issue involves two separate elements. Bureaucratic influences within firms may limit the concentration of power. But even if they do not, policies have been designed to ensure that regulators can prevent the concentration of powers.

In any case, the concentration of power argument has limited relevance to the deregulation of financial institutions. It would apply primarily to the extension of powers to the chartered banks, the group persistently identified with the argument.[3] The concentration of power argument becomes an obstacle to the deregulation of other financial institutions only if the process of deregulation itself must be balanced between institutions. Such a need for balance in deregulation contradicts the concentration of power argument. Presumably, it is the imbalance in favour of the chartered banks which motivates the concern about concentration of power.

The status of the four pillars

The final aspect of the four pillars argument to be considered is its accuracy as a description of Canada's system of financial institutions, either now or in the past. W.A. Kennett described the four pillars concept as follows:

> It will be observed that there is a common factor linking the previous Bank Act, the White Paper and the present Bank Act. This factor is a policy which recognizes the common participation of various groups of financial institutions in our financial system, but identifies and respects the differences in the main function performed by each group. Each group has a 'core' function, e.g., 'underwriting' for investment dealers, 'fiduciary activities' for trust companies, 'commercial lending' for banks, 'insurance' for insurance companies. (Cited in Ontario 1983b, p. 14)[4]

However, Kennett goes on to add that:

> the policy recognizes the benefits to be obtained by controlled competition that permits institutions to offer supplementary services which compete to some extent in the core area of other groups. For example, trust companies do some commercial

> lending, banks do some dealing in securities, investment dealers trade in foreign exchange and assist in intermediation. (Cited in Ontario 1983b, pp. 14-15)

A different perspective on the degree of overlap of functions of different financial institutions is presented by Petras in his submission to the OSC. As shown in Figure 1, his summary of the functions undertaken by different institutions suggests that overlap rather than specialization is the rule in Canadian financial markets. Moreover, functions have evolved over time. Trust companies, for example, started solely as trustees, but eventually the provision of pooled trusts for customers developed into a function indistinguishable from the deposit-taking activities of chartered banks.

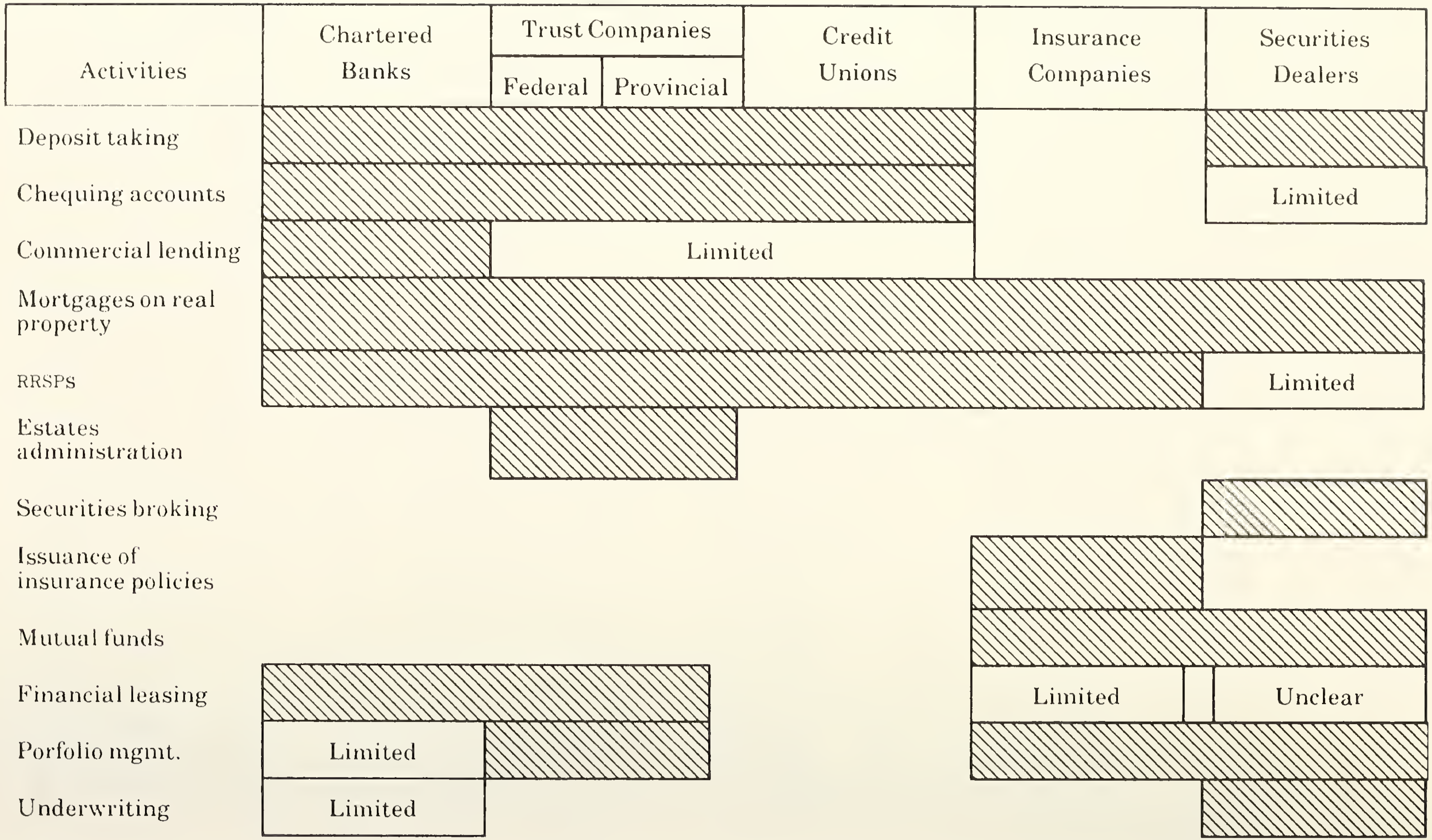
The obstacles in perspective

This section has reviewed some of the frequently invoked obstacles to deregulation. The four pillars concept does not appear to be an insurmountable obstacle. Conflicts of interest can be dealt with and have been dealt with successfully in ways other than rigid separation of powers. Concentration of power provides, at best, an argument against extension of powers for chartered banks, but seems of little relevance to changing powers of other financial institutions. Moreover, the four pillars concept appears to be a limited characterization of both the development and the present state of the division of functions among financial institutions. Finally, while the tension between federal and provincial authorities appears to be a greater obstacle to deregulation, the Quebec experience suggests that provincial governments have some scope to ease the regulatory constraints on financial institutions under their jurisdiction.

ALTERNATIVE APPROACHES TO REGULATION

The suggestion that the traditional obstacles are less than absolute does not mean that deregulation should proceed unfettered. This section argues that recognition of a need for regulation of financial institutions has important implications for the process of deregulation.

FIGURE 1



SOURCE: David Petras, 'Financial products and services provided by financial institutions', Ontario Securities Commission, Meeting and Hearing on Discount Brokerage and the Role of Financial Markets.
Shaded areas = Permitted.

How a proposal for deregulation might be implemented depends on the underlying assumption either that the activity need not be regulated at all or alternatively that the current system of regulation governing the activity is inappropriate, and possibly excessive, for achieving the goals of public policy. If an activity need not be regulated, removal of all regulation would be beneficial. On the other hand, if a case can be made for some regulation, deregulation must proceed in such a way as to preserve the goals of the regulation.

The need for regulation

The analysis of this paper is based on the assumption that financial markets require some regulation by public authorities. This assumption is justified by a two-stage argument. First, the state has the function of supplying a system of contract law for the enforcement of contracts and the prevention of fraud.[5] Second, the nature of the business of financial institutions makes recourse difficult for wronged parties when the other parties to the contract fail to meet their obligations. Much of the value of a financial institution as a going concern results from the confidence held by its customers that it will honour its obligations. This value would be destroyed by the failure of the institution to meet its commitments.

The fact that financial institutions require some form of regulation necessarily constrains the process of deregulation. It must proceed with an understanding of the role of the various parts of the existing system of regulation and their contribution to its goals.

An analogy can be drawn with airline deregulation. While many would argue that fares and entry into the industry need not be regulated, fewer would argue that airline safety should be left completely unregulated. Yet it could be argued that strict entry requirements could limit the airline industry to firms with established reputations that would have much to lose from a poor safety record.[6] As a consequence, safety regulation need not be administered as assiduously as it would be if the industry also included numerous small airlines. Thus, the types of safety regulations and the mechanisms used to enforce them cannot be considered independently of other dimensions of regulation applying to the airline industry.

Prudential versus market regulation

The airline industry analogy has a parallel with the types of regulation used in the financial industry. A distinction can be made between prudential (or behavioural or portfolio) regulation and market (or structural) regulation in the financial industry. Prudential regulation refers to the set of rules that govern the activities of enterprises participating within the industry and can be considered as similar to safety regulation in the airline industry. Market regulation governs the conditions under which enterprises become eligible to be certified as a particular type of financial institution or to carry on some type of financial activity.

The dividing line between prudential regulation and market regulation is obviously not hard and fast. A rule preventing banks from trading in equity securities on behalf of their customers is viewed as a prudential regulation from the standpoint of the banks but as a market regulation from the perspective of the investment dealers.

The distinction between prudential and market regulation can be established more clearly by considering examples of each. Among the prudential regulations governing the chartered banks are limits on their holdings of residential mortgages and the level of their equity investment in any business enterprise. Similarly, the behavioural regulations governing trust companies include restrictions on commercial lending and maximum borrowing-to-capital requirements. In contrast, the market regulations for chartered banks and trust companies are illustrated by incorporation requirements such as minimum initial capital rules contained in the Bank Act and trust company legislation.

Rule versus discretion

The policies governing financial institutions can also be classified on the basis of another criterion: the approach taken to regulation. A distinction can be made between regulation by rule and regulation by discretion. Regulation by rule refers to a regime in which certain rules are established which apply equally to all affected institutions. Moreover, the rules generally remain unchanged in the face of changing conditions, especially the condition of the financial institution itself. Regulation by discretion, in contrast, refers to a regime

in which the regulator may apply regulations in differing degrees to different institutions and in different economic circumstances.

The difference between rule and discretion will also be reflected in the regulators' surveillance of and contact with regulated institutions. Regulation by rule requires only that the regulator establish that the institutions conform with the rules. Discretionary regulation requires more in that the regulator must acquire a basis for determining the setting of the regulation to be applied to each institution.

A classification of regulation

Two different ways of viewing the regulation of financial institutions have been developed in the preceding discussion. One views the approach (rules versus discretion) taken by the regulators, whereas the other views the objective (prudential versus market) of the regulation. These approaches are overlapping rather than exclusive. The regulations governing every type of financial institution include elements of both prudential regulation and market regulation. Similarly, a policy objective may be fulfilled by a combination of rules and discretionary approaches. Therefore, the overall policy which applies to any type of financial institution can be classified as one of four types:

1 Market – discretion, prudential – discretion
2 Market – rule, prudential – discretion
3 Market – discretion, prudential – rule
4 Market – rule, prudential – rule

Each of the first three types of regulation has a counterpart in the actual systems used for the regulation of financial institutions in Canada or the United States and is discussed more fully below. The fourth type of regulation lacks any such counterpart and is not discussed any further.

Market – discretion, prudential – discretion

This approach describes the regulatory approach now applied to foreign-owned or Schedule B chartered banks in Canada. Foreign-owned banks are not assured approval of their application for incorporation by meeting some set of objective criteria. The discretionary

aspect of the market regulation can be illustrated by the procedures to be satisfied by the applicants for entry as a Schedule B bank. Section 8(d) of the Bank Act states:

> Notwithstanding subsection 7(2), letters patent incorporating a bank shall not be issued . . . (d) where the bank thereby incorporated would be a foreign bank subsidiary, unless the Minister is satisfied that it has the potential to make a contribution to competitive banking in Canada . . . .

Moreover, the application to become a Schedule B bank is judged subject to the criteria presented in Table 1. In several cases, the elaboration of the criteria indicates the discretionary aspects, i.e., the possibility for exceptions. In addition, the Inspector General of Banks clarifies the role of these criteria:

> These criteria are listed for informational purposes only. Though these criteria are deemed generally desirable, the Minister of Finance along with the Governor in Council, in the case of letters patent, and Parliament, in the case of a special act, have the ultimate responsibility for approving applications. (Inspector General of Banks, December 1980, p. 6)

The discretionary nature of the behavioural regulation governing Schedule B banks can also be illustrated by the directives or guidance provided to these banks by the Inspector General. Consider the letter sent to all Schedule B banks with respect to prudential lending limits.

> When each foreign bank's subsidiary was licensed, a restriction was placed on the licence regarding transactions between the foreign bank's subsidiary and its parent or other affiliates of the parent. It required that the loans to the parent and other affiliates which exceeded 20% of the Bank's equity must have the approval of 2/3 of the Bank's Board of Directors. (Inspector General of Banks, 20 October 1983, p. 1)

The Inspector General also expressed surprise and concern with the extent of upstream lending, given his expectation that such lending would be only occasional and for a short term. He concludes:

TABLE 1
Criteria for establishment of Schedule B banks

1 The applicant must be a foreign bank ....
2 The applicant should be of sufficient asset size to support a foreign bank subsidiary in Canada ....
3 The applicant should have had a favourable earnings record over the last 5 years....
4 Ownership of the applicant should be widely-held....
5 The home jurisdiction should report favourably on the applicant....
6 The applicant should be well supervised in its home jurisdiction....
7 The applicant must demonstrate that Canadian banks receive or will receive similar competitive opportunity to that afforded indigenous banks operating in the home jurisdiction....
8 The applicant must be able to demonstrate a potential to make a contribution to competitive banking in Canada....
9 The applicant is expected to provide a letter of comfort with regard to the foreign bank subsidiary.

SOURCE: Inspector General of Banks, December 1980, *A Guide for Foreign Banks*, pp. 7-10.

> I am asking you to be guided by the following constraints.
>
> Firstly, ... this office would expect any upstream lending to be for short-term liquidity arrangement purposes, that is for a period of no longer than 30 days. Upstream lending for a period longer than 30 days is not considered by this office to be for liquidity purposes and banks should, therefore, refrain from such lending.
>
> Secondly, my letter of October 14, 1982 ... set out this office's views on prudential lending limits. It indicated that each foreign subsidiary should limit the size of credit facilities granted to any one borrower or group of borrowers with common management to 100% of the Bank's shareholders' equity and reserves ... It went on to say that the normal practice of the Bank should be to limit the size of loans to no more than 50% of shareholder's equity and reserves and that the 100% limit should only be used rarely. This office expects that the maximum size of loans to parents and affiliates should be not greater than 50% of shareholders' equity and reserves. (Inspector General of Banks, 20 October 1983, p. 2)

The Inspector General has in other letters offered guidance with respect to the role of a foreign bank subsidiary, prudential lending limits, funding of Canadian-dollar denominated assets, special purpose companies, non-current loans, and leverage ratios. The same type of discretion which characterizes the entry of foreign banks appears to characterize the regulation of the behaviour of existing Schedule B banks.[7]

Market – rule, prudential – discretion

This approach consists of market regulation by rule and behavioural regulation by discretion. While not perfectly applicable, it is probably the best description for the regulatory approach for trust and loan companies. Technically, trust and loan companies that wish to become incorporated in the provinces must gain letters patent at the discretion of the Lieutenant Governor in Council. The large number of new incorporations over recent years suggests that the requirements are relatively easily satisfied. Indeed, the Ontario Ministry of Consumer and Commercial Relations, in apparent recognition of the ease of gaining incorporation, has argued that:

> the criteria to be satisfied by the applicants should be stricter to assure that only persons with high standards and integrity are given the powers and responsibilities involved. (Ontario Ministry of Consumer and Commercial Relations 1983a, p. 16)

The behavioural regulation governing trust and mortgage loan companies incorporate provisions which clearly grant discretion to the regulators. Trust and mortgage loan companies are subject to limits which set a ceiling to the borrowing which these companies can undertake in relation to the equity held by their shareholders. The borrowing ceilings are set in the legislation at 12.5 times the excess of a company's assets over liabilities. A higher limit may be approved by the Minister once a trust company has passed a bylaw authorizing a higher limit. Still, section 70(9) of the Trust Companies Act provides that:

> The Minister may, on the recommendation of the Superintendent . . .

a) approve the limit provided by the by-law or by the directors' resolution, as the case may be, or

b) prescribe a limit lower than the limit provided by the by-law . . .

and he may, on the recommendation of the Superintendent, revoke any approval or prescription of a limit and prescribe a lower limit.

Thus, while the ceilings are not set in the legislation, the regulators have the power to set a ceiling for each individual trust company and adjust this ceiling as circumstances warrant.

Market – discretion, prudential – rule

The regulation of the chartered banks conforms most closely to this model, even though some changes in the Bank Act in 1980 added to the regulator's discretion. Prior to 1980, new chartered banks could be incorporated only by special act of Parliament. Shearer et al. (1984), noting that only two new banks were incorporated between 1925 and 1966, argue that the most formidable barrier to entry was the incorporation barrier in the form of the requirement to obtain three readings of a private member's bill, cross-examination in committee, and review by the government to see that all legal requirements had been met. In the case of the Bank of British Columbia, the entire process took over four years from initial petition to the opening of business.

The 1980 legislative changes made chartering as a bank easier. Banks could be incorporated by letters patent. In addition, domestic banks were permitted to incorporate under Schedule B so as to avoid the limit to ownership by any one interest. But considerable discretion can still be exercised with respect to new applications. The power provided by section 7(2) of the Bank Act leaves approval of applications with the minister of finance 'with the approval of the Governor in Council but otherwise at his sole discretion.' While similar provisions exist with respect to the incorporation of trust and mortgage loan companies both federally and provincially, only two new chartered banks (other than foreign-owned subsidiaries under Schedule B) were established between the end of 1980 and the end of 1983 during a period in which at least nine trust and mortgage loan companies commenced business.

The rules approach to prudential regulation can be illustrated by the relationship that exists between the Inspector General and the chartered banks. The present powers of the Inspector General are contained in section 242(2) of the Bank Act:

> The Inspector, from time, but not less frequently than once in each calendar year, shall make or cause to be made such examination and inquiry into the business as the Inspector shall deem necessary or expedient as necessary.

The current Inspector General has stated in testimony before the Finance, Trade and Economic Affairs Committee of the House of Commons that his total staff consisted of only twenty-one people and that the annual inspection could be best described as a 'management audit of the banks.' (Canada 1982, p. 31).

Some movement away from regulation by rule occurred following the 1980 Bank Act. It incorporated regulations which were to be determined by and could be altered by the minister of finance. Power and Varma (1984) report sixteen regulations which were applied to the chartered banks over the period from December 1980 to August 1983, some seven of which refer to the business powers of the banks. Thus, even though the behavioural regulation of the chartered banks can be classed at the rules end, the latest change of the Bank Act increases the role of discretion in the regulation of the banks.

The Canadian approach to the regulation of commercial banks, which emphasizes rules, can be contrasted with the more discretionary approach followed in the United States. The American Enterprise Institute (1984) described the duties of the Controller of Currency and the Federal Reserve Board, the two major regulators at the federal level:

> The FRB determines which activities can be performed in bank holding companies and in new bank subsidiaries of such companies under the statutes' authorizations of their performance of activities determined by the board to be closely related to banking and to managing or controlling banks.
>
> The Controller of the Currency must approve applications for the formation of national banks .... He arranges their examination of these banks to determine the financial soundness,

> quality of management, and compliance with laws and regulations. He regulates and supervises the trust activities of these banks and is responsible for the disclosure, reporting, proxy requirements and securities activities under federal securities laws. (American Enterprise Institute 1984, p. 7 and p. 16)

PREREQUISITES TO DEREGULATION

The analysis to this point has classified different approaches to regulation and has identified them with the major approaches taken to the regulation of financial institutions in Canada. An understanding of these differences in approach gains significance with respect to two apparently incompatible positions which may be taken with respect to the deregulation of financial institutions in Canada. On the one hand, it can be argued, following the Porter Commission and the Economic Council of Canada, that it is desirable to gain greater competition in Canadian financial markets by reducing barriers between types of financial activity. On the other hand, recent events in Canada suggest that concern for depositor safety must be given substantial attention in any regulatory reform.

The opening up of activities to new entrants may require a re-examination of the nature and form of prudential regulation. Consider a reform which permits entry of new firms into an activity in which emphasis in the past has been placed on discretionary regulation of entry. This discretionary approach to entry may have permitted reliance on the use of rules for behavioural regulation for the purpose of protecting creditors. The entry of institutions that must be governed by an approach to regulation that emphasizes stringent rules of behaviour may alter the entire balance of regulation if they are to operate under the same prudential rules as existing firms. The degree of screening of entrants which characterized the treatment of the original participants will now be absent for the newcomers.

The process of deregulation in a financial system that embodies a variety of approaches to regulation poses a serious dilemma for policy makers in trying to maintain the same prudential standards while easing market regulation. The avoidance of this dilemma could take either of two approaches. The regulation-by-function approach proposed by the Economic Council would lead to the application to all

entrants of rules which are appropriate to the performance of the new activity regardless of the basis of the incorporation of the new entrants. For example, if self-dealing is judged an important problem for any institution which carries on commercial lending financed by deposits from the general public, the prohibition on concentrated ownership contained in the Bank Act might be applied to all financial institutions carrying out both commercial lending and deposit-taking activities. Regulation-by-function would not dictate that all provisions of the Bank Act would have to be applied to all institutions wishing to make commercial loans. Some, such as cash reserve requirements and limits on mortgage holdings, may be justified on grounds other than the problems of combining commercial lending with deposit taking.

In general, regulation-by-function would not require that only one rule be established for all institutions performing a function. Differences in rules could be applied to institutions according to their ability to meet certain objective standards. A variable premium system of deposit insurance represents a discretionary form of rule regulation which would take account of differences among individual institutions. To be consistent with regulation by function, the premium should not take account of the institutional incorporation of any financial intermediary but should instead be based on objective criteria.

An alternative to the regulation by function approach suggests that there can be more than one way for regulation to overcome a problem posed by deregulation. The Bank Act limits the prospect for self-dealing that results from combining deposit taking and commercial lending by prohibiting concentrated ownership of Schedule A banks.[8] On the other hand, a variety of other approaches could be used with different devices applied to different types of institutions. Self-dealing could be controlled by limiting the types of transactions and terms of transactions between associated enterprises. Alternatively, the sanctions applied for abuses of self-dealing could be strengthened. For example, the veil of limited liability could be pierced when abuse of self-dealing creates losses for depositors.[9]

The point, however, is not that any of these approaches are inherently superior to avoidance of concentrated ownership; rather, there may be several approaches to dealing with the problem. This point becomes especially relevant when deregulation in terms of

market regulation opens an activity to new participants. The appropriate prudential regulation may have to give recognition to the different circumstances of new entrants relative to the existing participants. Failure to do so can lead to either of two opposite dangers. Concern for depositor safety may cause undue resistance to the easing of competitive regulation. Alternatively, concern for greater competition through reduced market regulation may jeopardize safety unless differences among regulatory approaches are recognized.

In conclusion, deregulation should not be viewed as a one-way process. In order to gain scope for greater competition in financial markets by reducing regulations that inhibit entry into different types of financial activity, we may need to rethink and even strengthen the set of prudential regulations which govern the performance of these activities. Many recent developments in financial markets, especially technological and organizational innovations, have eroded the effectiveness of market regulation. This adds urgency to the task.

NOTES

1 It may be argued that changes in the Bank Act have removed barriers to entry into banking, making it easier for other institutions to gain broader powers by converting themselves into banks.
2 For a theoretical analysis that examines sources of intergovernmental conflict with respect to regulation of financial institutions, see Chant and Dean (1982).
3 For an attempt to defuse the argument with respect to the chartered banks, see Canadian Bankers' Association (1985).
4 It is interesting that 'commercial lending' is defined as the core function for banking. This function does not appear to have been the consideration that made banking a federal responsibility under the BNA Act. The 'banking and currency' provisions seem to be more related to the function of making payments.
5 A similar justification for government action to establish monetary arrangements is offered by Milton Friedman, who argues:

> What is involved is essentially the enforcement of contracts, if the failure of an issue to fulfil his contracts is in good faith, or prevention of fraud, essentially of counter-

> feiting, if it is not. Both are functions that most liberals would wish the state to undertake. It so happens that the contracts in question are peculiarly difficult to enforce and fraud difficult to prevent. (Friedman 1960, p. 6)

6 See Klein and Leffler (1981) for a discussion of the way in which concern for reputation may lead a firm to assure the quality of its product to consumers. An earlier application of the general theory to banking can be found in Klein (1974).

7 For further discussion on this point and on the foreign bank reaction, see Chant (1984).

8 It is not clear the avoidance of concentrated ownership eliminates the principal-agent problem embodied in self-dealing; it may just change its form. See Chant (1979).

9 At one time, common stock of chartered banks in Canada were subject to double liability. For a general discussion of the issue of piercing the corporate veil, see Posner (1973, p. 178).

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The changing nature of the financial services sector

Lawson A.W. Hunter

INTRODUCTION

The traditional view of the financial services industry as consisting of distinct compartmentalized institutions, each with its own inviolable functions, is increasingly being called into question by the reality of today's financial services markets. Developments that continue to take place in the industry, such as the emergence of new and innovative financial instruments and services, and the technological advances that have made them possible, have changed the face of the financial services sector.

These developments have caused financial institutions to evolve in a manner that has deviated substantially from their historical roles and charters, to the point that there is now significant overlap in the types of services they offer. A strong argument could in fact be made that the 'four pillar' characterization of the industry has long been inappropriate. Some twenty years ago, the *Report of the Royal Commission on Banking and Finance* (Porter Commission) recognized and indeed welcomed the emerging phenomenon of increased inter-pillar competition.

The current degree of activity overlap between different types of financial institutions points to the fact that firms have found it possible and desirable to innovate within their regulatory constraints and offer types of instruments and services that had previously been the preserve of others. This has triggered concerns that the existing

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institutionally based regulations are becoming irrelevant; and regulators are devising appropriate responses to these developments.

THE GOALS OF FINANCIAL POLICY

In shaping their responses, regulators must certainly give careful consideration to the goals of financial policy. Clearly, the traditional operational concerns of financial regulators have been solvency and the control of conflict-of-interest abuses. These continue to be of paramount importance today. Efficiency and competition are also important goals of financial policy, and have been identified as such in the federal government's recent Green Paper.

While there is an increasing acceptance of the concept that efficiency is best achieved by regulating markets in the manner that is least restrictive of competition, it is also true that in the case of financial institutions, there is an inherent trade-off between efficiency on the one hand and institutional solvency and system stability on the other. The problem arises from the fact that it is impossible, *a priori*, to predict to what extent institutional exit (failure) will have a contagion effect and lead to a system-wide loss in confidence. The issue is further complicated by the fact that financial institutions are highly leveraged and are closely linked through loans and other assets. Consequently, the failure of any one institution will generally result in losses for other institutions. This is an important and difficult issue for regulators. In my view, it is vital that the means that legislators devise to ensure solvency and control conflict-of-interest abuses are not so stringent as to impede competition unnecessarily as an effective tool for encouraging greater efficiency in our capital markets. The appropriate extent and form of regulation will ensure that we meet the traditional objectives of financial regulation in the manner that is least restrictive of competition in order to ensure the efficient allocation of resources. As the *Interim Report of the Ontario Task Force on Financial Institutions* (1984) noted, 'a financial system, rigidly controlled for solvency, may provide neither the range of investments nor the flexibility for optimum market efficiency. The goal of public policy in this critical sector must be to balance these two considerations' (p. 13).

CONCENTRATION AND COMPETITION IN FINANCIAL MARKETS: TRADITIONAL CONCERNS

In the current discussion about how best to re-regulate our financial system, a number of observations and predictions have been made concerning the state of competition, concentration, and dominance in the financial services sector. Concern has focused on two areas: the growth and impact of financial conglomerates, and the spectre of bank dominance in the financial services industry. I would like to speak to both of these issues in this paper.

We have heard a lot of talk lately about the chartered banks' control of fully 61 per cent of the Canadian financial industry's total assets, as compared with a mere 12 per cent for life insurance companies, 8.7 per cent for trust companies, and 6.2 per cent and 1.4 per cent for credit unions/caisses populaires and investment dealers respectively. The argument is then made that the banks would, unless restrained, run roughshod over the other pillars in an environment of relaxed regulation. In their defence, the Canadian Bankers' Association has countered with the argument that these data actually overstate the banks' relative size, due to the inclusion of their foreign assets, while understating the size of the trust and insurance companies by excluding their sizeable assets under administration.

Regardless of numbers, I criticize a method that proclaims that aggregate industry asset and aggregate product data are meaningful evidence of bank dominance and overwhelming market power in the financial services sector. Institutionally based comparisons of the type just mentioned are simplistic, inadequate, and inappropriate measures of concentration, of dominance, or of the extent of actual or potential competition. For a start, this approach completely ignores the individual markets for financial services. These types of data are not proxies for any market.

The relevance of defining the market

Clearly, we cannot begin to discuss sensibly or have a proper perspective on concentration, dominance, and competition until we address the vital issue of what are the relevant markets. In defining any market, consideration must be given to such factors as the product and geographic and functional dimensions of the market, from the perspective of both users and suppliers. For these reasons, even the

available product market data, based on broad classes of financial services such as commercial lending, consumer loans, and residential mortgages, which provide aggregated data on the relative share of the business accounted for by each type of institution, do not give us an accurate picture of competition in actual 'markets'. Consider the following examples.

The activity of business financing is very diversified. Business financing can take the form of short-term demand loans, medium- and long-term debt financing, and equity financing and can involve direct demand and term lending by financial intermediaries and the underwriting and placement of debt and equity through the capital markets in Canada and abroad. The so-called business finance market is in reality a spectrum of diversified submarkets, each with a different mix in terms of the size and types of players involved, their degree of participation, and the variety of instruments available to them.

In most respects Bell Canada does not access funds in the same 'business finance market' as does the local entrepreneur. Large multinational Canadian corporations have direct access to the financial markets of the world for the placement of their debt and equity instruments. Similarly, Canadian bankers and securities underwriters have to compete with international intermediaries to win much of their business. Contrast this with the small unincorporated enterprise that is generally restricted in its choice of instruments and, depending on whether it is located in a large city or a small rural town, it may have a broad choice in terms of the number or range of different financial institutions to service its business loan needs, or no choice at all. Consider also that the competitive environment will change quite dramatically for the medium-sized business when it reaches the size where it can start to issue securities.

The importance of the geographic dimensions of the market must also be recognized. That in Quebec the Caisse Desjardins locations – which are an important source of consumer loan funds – outnumber all other financial institutions *combined* is not reflected in aggregated data, which show the banks accounting for 67 per cent of consumer lending in Canada. For that matter, of the 1,214 communities in Quebec that have deposit-taking institutions, 845 – some 69 percent – are serviced exclusively by caisses populaires! A similar alternative to banks clearly exists for individuals and small businesses needing loans in Manitoba and Saskatchewan, where co-operatives are a very

prominent force, having 33 per cent and 45 per cent of all institution branches respectively. Aggregated national data really are not a useful measure of competition or dominance in what in this case are actually hundreds of distinct consumer loan 'markets' in Canada. The same type of market reality surely faces the suppliers and users of small business loan funds. Thus, while some financial firms may be extremely large in terms of total assets or revenues, these individual firms are not necessarily dominant in any particular market for financial services.

These few examples serve only to illustrate what I believe to be the essential first step in establishing a framework from which to approach the concentration, dominance, and competition issues and to point to the inadequacy of aggregated data as a basis from which to derive ad hoc indicators about concentration in particular financial services 'markets'. Relevant data may well prove to be very difficult to gather, due to the multidimensional nature of many market segments, but it is essential that we have a more precise analytic framework and, if possible, relevant empirical data about the nature of the instruments and players in these market segments, if we are to address these issues.

Competitive analysis in financial markets

Once we have begun to focus on the correct markets, the analysis to reveal actual or potential abuse due to dominance has just begun. The connection between structural variables such as concentration in a market and conduct or performance is considerably more subtle than can possibly be captured in crude indicators such as the share of a market held by a particular institutional type.

One issue at the heart of concerns about concentration and removing interpillar barriers to entry is the judgement about whether one particular corporate configuration engaged in multiproduct and multimarket activities will have such large economies of scale or scope that it will be able to drive out all other competitors. To draw that judgement requires, among other things, a knowledge of economies of scale and scope in the production, distribution, and marketing of financial services. Policy analysts must also have a sophisticated and subtle knowledge of how competition takes place in the various submarkets, so that the comparative strengths and weaknesses not only of the various institutional types but also of the

particular corporations involved can be judged. The extent and nature of the legal and economic barriers to entry that determine the contestability of the various market segments will also be critical.

Consideration has to be given to the practical strategies available for new entrants to establish initial toe-holds and to grow in individual markets. Typically, this is done by identifying a vulnerability in the existing suppliers' strategies and focusing on it. For example, a particular submarket such as sophisticated institutional investors, agriculture, medium-sized manufacturing, or an ethnic group may be neglected. The new entrant can specialize in serving that niche by developing better knowledge, delivery strategies, and products. Once established, the new entrant can subsequently expand.

I would like to recall one topic that was a hot issue in the financial press months ago but with notable and important exceptions seems to have disappeared from the current debate on dominance and competition – namely, marketing. At the retail level, the financial market appears to be taking on many of the attributes of other common consumer commodities. In the retail market, typically, the consumer is less sophisticated and knowledgeable, and convenience is a major factor. From the production side, mass marketing requires standard products and typically relies on advertising to create the image of product differentiation and brand loyalty. Brand loyalty is then frequently used to sell groups of related products. In this kind of world, a careful assessment must be made of the competitive advantages available to the different firms. The widely dispersed branch network of the banks, caisses populaires, and co-ops needs to be compared with the unique delivery systems of the insurance companies and securities dealers with their reliance on brokers and company salespeople. Each of these systems will have different advantages relative to different markets, submarkets, and niches. Indeed, at this stage it appears that there is every reason to believe that each of these delivery systems will have unique advantage with regard to some particular market segments and that no one system will have a decisive advantage in all submarkets.

The analysis of comparable advantages and disadvantages of the marketing and distribution systems becomes even more interesting when one factors in the role of electronic funds transfer and the emergence of automated teller machines (ATMs). The recent announcement

that four major banks and the Caisse Desjardins in Quebec plan to create a single integrated network, 'Interac', that would allow cash to be withdrawn from accounts of any participating firm is significant for several reasons. One can ask what competitive factors led the Royal Bank, which had by far the largest ATM network, to join the group. Similarly, one should ask whether the restriction of the network to withdrawals will be maintained for long, since this design appears to continue to confer a strategic advantage on the companies with large branch networks. Also, if it is possible for simplified insurance or securities to be sold through ATMs, then the current strategic marketing advantages of different firms in these industries would change with regard to specific market segments.

Will the banks dominate all these markets? It is difficult to say at this stage, but one clue might come from the response you would expect from a small businessman if you asked him what he thinks about the way banks market their loans.

While the foregoing discussion has touched on some of the factors in the retail market, an equally interesting discussion pertains to marketing to the larger and more sophisticated participants in different market segments. For example, the Ontario Securities Commission (OSC) has traditionally divided its regulation between the sophisticated exempt market and the retail market. No one would deny that sophisticated buyers are much more capable of demanding and getting uniquely tailored products and services that suit their special needs. They are much more knowledgeable about their needs and the options available, and they will force unbundling of products when it suits them. We have also seen in the securities business that frequently the intermediaries firms that are most successful in this market are not the same ones that are at the top of the ladder in the retail market.

In this sophisticated market, totally different marketing and delivery systems will have the advantage. Obviously, a greater premium is paid for good information and analysis. Dedicated and highly creative account executives will be crucial. Access to major blocks of capital will also be important. These obvious factors will also be supplemented by more subtle items such as the ability of some institutions to provide on-line computer services rather than batch processing. For firms with a major interest in cash management, this could be a determining factor.

The purpose for going through these examples of the nature of competition in the financial markets is simply to emphasize that undertaking a meaningful competitive analysis is a sophisticated task. Failure to consider these factors carefully could lead policy analysts to conclude that the earth is flat. The right analysis is no doubt being conducted by the industry's strategic planners. Unfortunately, little of it appears to have been brought to bear on public discussion of competition, dominance, and concentration. Instead, the fact base of the policy debate is stuck on the share of assets 'controlled' by various pillars, and, as I have said, this tells us very little.

It is interesting to note, however, that in response to the release of the Green Paper's proposals for discussion, many types and sizes of financial firm have begun to plan for diversification into other activities, including banking, where they will face the 'big five'. This suggests that the future may see a decline in the relevance of any discussion about institutional types and a new focus around companies and corporate groups. In that environment, we can already identify at least 15 to 20 important players in addition to the large banks. So the question is, regardless of the size of the individual firms in this environment, will there be sufficient vigorous competition to ensure an efficient and dynamic financial market? This question cannot be answered by a simplistic debate over the assets held by various institutional groups.

Regulatory barriers to entry

I would like to turn now to one of the small number of critical concepts in any competitive analysis. The most fundamental is the contestability of a market. This requires an analysis of the presence and impact of regulatory or other barriers to entry that may make it possible for anticompetitive practices to exist over time. Where barriers to entry and exit are low and markets are highly contestable by incumbent firms or new entrants, then abuse of market power is extremely unlikely to develop.

There are many financial regulations that serve to impede entry and restrict the degree of competition between firms in the various so-called pillars. This could lead to situations in which abuse of dominance could exist. I would like to comment on two general groups of regulations that restrict entry and hence have a major effect on the competition analysis. These are the restrictions on the business

powers of domestic financial institutions that serve to narrow the line of business of individual firms, and foreign ownership restrictions that tend to limit the participation of these firms.

Restrictions on the business powers of domestic financial institutions

At present both the federal and provincial statutes and regulations that govern the business activities of a wide range of financial institutions restrict the types and amounts of financial services they can provide and the investment instruments they can hold.

The business activities of trust, mortgage loan, and insurance companies, to name a few, are prescribed in this manner by their governing statutes. Thus, these companies are largely prohibited from offering financial services or from investing their funds in assets that are not explicitly set out in the provisions that define their business powers. This regulatory concept of prescribing permissible business activity is the opposite to that of the Bank Act, which grants the banks general powers of investment and lending, subject to certain restrictions, including a prohibition on banks on the underwriting of securities and the offering of discretionary trust services and restrictions on their direct participation in the residential mortgage field to 10 per cent of their total Canadian dollar liabilities. (The banks, of course, are also required to maintain reserves that yield no earnings for them.)

Of particular note concerning the business powers of trust and loan companies are the statutory limitations on the amount of commercial and consumer loans they can make. The sum of such loans cannot exceed 7 per cent of the lender's capital and guaranteed funds and must be made through the 'basket clause'.

Aside from restrictions on their business powers, trust and loan companies must also abide by financial standards regulations that dictate that at least two-thirds (75 per cent for provincial corporations) of their total assets must be invested in residential mortgages or other 'quality' assets in order to be allowed to maintain reasonable leverage. In recent years this has come to be seen by these companies as increasingly restrictive, in view of the fact that this market is highly competitive on the supply side and has shown signs of being in relative decline on the demand side, for demographic and other reasons.

Life insurance companies face other restrictions. They are prohibited from issuing bonds and debentures to raise funds and are unable to offer financing services to consumers for the purchase of their own insurance and annuities. Neither can they act as agent in connection with the sale, purchase, or redemption of government securities.

There are, of course, a number of other types of institutions that comprise our financial services industry. Investment dealers, caisses populaires and credit unions, as well as pension and mutual funds and others, all have their own sets of regulations which, to a greater or lesser degree, prescribe the nature and scope of their business activities.

The above examples are illustrative of the regulatory restrictions that I believe have limited significantly participation by the non-banks in a number of important segments of the financial services market. Moreover, in a more general way, these restrictions have affected the absolute size and growth of these institutions' asset bases by denying them full flexibility to keep pace with the ever-changing nature of financial markets, to take advantage of investment opportunities as they arise, and to position themselves to compete more effectively for the savings and investment dollars of Canadians. Further, detailed restrictions on the business powers of financial institutions not only limit their ability to diversify their investment portfolios and thus reduce the risk of loss, but also hamper the critical task of matching asset and liability maturities.

Foreign restrictions

The foreign ownership restrictions that apply to most financial institutions certainly represent a major barrier to increased competition and entry in our financial services markets. To my knowledge, the stringency of certain of these restrictions does not appear to be fully justified by sound economic analysis. Indeed, the nature and type of restrictions vary widely across the financial sector. As we well know, financial markets are becoming increasingly internationalized in nature and scope. If we want Canadian industry to be able to get access to funds at the best rate possible, we cannot insulate ourselves from the world's financial markets. I think it will become increasingly evident that barriers that impede capital movement into

Canada can be maintained only at an economic cost to Canadian users and suppliers of capital.

In my view, it is time to re-examine the rationale for limiting foreign participation in our financial markets. Easing of these restrictions could not help but promote a more efficient domestic industry that will be more responsive to the needs of users.

The above discussion of the effects of regulatory barriers to entry is only one of the most obvious features of the competitive analysis that must be done before the public policy process will be able to make sense of the arguments about competition and dominance. As I have said, even the most basic work has not been done. This includes defining the markets, analysing the character of competition in these markets, assessing contestability, and determining the relative strengths and weaknesses of individual firms in these markets as well as those of potential new entrants.

I would like now to turn briefly to conglomerates in order to explore two specific problems that have been identified and to examine the regulatory options that would appear to achieve public policy goals in a manner that is least restrictive of competition.

CONGLOMERATES: THE MINIMUM REGULATION TO ENSURE EFFICIENT RESOURCE ALLOCATION

What are they? How big are they?

There seems to be a widespread and growing concern today that economic power is becoming increasingly concentrated in the hands of a few individuals and corporate entities.

The extent of this concern seems to be rivalled only by the discrepancies in the reports that have attempted to document the actual scope of their holdings. Articles last fall claimed that eight prominent families had control of 46 per cent of the Toronto Stock Exchange's (TSE's) 300 composite index. In December of last year, it was reported on *CBC Sunday Morning* that fully 80 per cent of all stocks traded on the TSE were controlled by the seven largest families. Just this May, the *Financial Post 500* presented a much more conservative – and in my view, probably a more accurate – estimate of their holdings, claiming that the largest eight controlled 44 companies on the TSE 300, representing some 15 per cent of the value of the index.

I would like to comment on the conglomerate phenomenon and present for consideration some data that have been prepared by my staff. For our purposes, it is convenient to identify two groups, which I will call economy-wide conglomerates and financial conglomerates. Many of their characteristics overlap, and, indeed, ownership links exist between the two. My purpose in this part of the paper is to present some preliminary data to highlight the existing reach of these corporate entities and to establish perspective and orders of magnitude. I must underline here the important caveat that these data are preliminary. However, the numbers involved are sufficiently large that the general observations I wish to make may not be sensitive to the kinds of adjustment that definitive accounting and statistical procedures would require. The drawbacks of the data are discussed more fully in the Appendix.

The discussion of economy-wide conglomerates that follows focuses initially on the twenty-five largest enterprises in the nonfinancial sector. The data have been drawn from sources published by Statistics Canada, and the term 'enterprise' relates to groupings of corporations (or firms) that have 50 per cent or more of their common voting stock under the control of a single corporate entity or holding company. The latest year for which these data are available is 1981, and they include information on federal and provincial Crown corporations.

The published statistics indicate that the twenty-five largest enterprises accounted for 29.2 per cent of total non-financial-sector assets in 1975 and 32.1 per cent in 1981. In absolute terms, these amounts are \$72 billion and \$172 billion respectively – an impressive growth of assets, even if measured in nominal terms.

Until 1980, the relative share of these enterprises increased by only one percentage point. Indeed, generally speaking, relative aggregate concentration measures are often typified as changing over decades at a 'glacial pace'. In this context, the subsequent two-percentage-point increase in one year is significant and can be attributed for the most part to the wave of conglomerate merger activity we witnessed four years ago. While more up-to-date information would be useful, there is nothing to my knowledge to suggest that the relative size of the twenty-five largest enterprises is today any less than what was registered in 1981. The trend in aggregate concentration since 1968 has been generally upward.

The confidentiality provisions of the Statistics Act preclude identification of individual enterprises, but the list of the twenty-five largest would certainly include Belzberg/First City, Bell Canada Enterprises, Black/Revelston, Cemp/Seagram's, Canadian Pacific, Desmarais/Power, Edper/Brascan, Genstar, Hiram Walker, Imasco, Nova/Husky, Reichmann/Olympia & York, Southern/Atco, Thomson/Hudson's Bay, and Weston/Loblaws. Each of these fifteen conglomerates meets the following criteria: the book value of its assets exceeded $1 billion at the end of 1983; its operations extend across three or more two-digit categories; and it is a public company in which effective control is believed to rest in Canada. The criteria have been applied with a certain amount of flexibility. For example, although the Foreign Investment Review Agency treated Imasco as a foreign corporation, the company's decision-making is thought to be sufficiently Canadian to include it in the list. Similarly, even though the Bell Canada family may not have quite met the diversification requirement, it is included as well.)

Using corporate annual reports, preliminary findings show that the combined total assets of these fifteen conglomerates for 1983 were $155 billion. Between 1980 and 1983, there was an increase in the assets of these giant complexes of $66 billion – an amount comparable in magnitude to the increase in total expenditures by Canadians on goods and services over the same three-year period. Of this $66 billion expansion, acquisitions accounted for nearly 25 per cent.

Let me now turn to sketch out a brief profile of the financial conglomerates in the Canadian economy. Unfortunately, Statistics Canada does not publish a parallel set of aggregate concentration measures of the type mentioned above for the financial sector. However, some sense of the size of financial conglomerates can be derived from individual corporate annual reports. Given the time frame and complexities involved in determining intercorporate ownership links, data for only one year, 1984, have thus far been analysed. The cluster of the larger financial conglomerates examined includes the following: Caisse Desjardins de Québec, Crownx Inc., E-L Financial Corporation, First City Financial, Genstar Financial Corporation, Laurentian Group, Power Financial Corporation, Traders Group Ltd., and Trilon Financial Corporation.

While the taxonomy of any group of this type is somewhat arbitrary, the common characteristics of the selected complexes are

that their (book value) assets exceeded $2 billion in 1984 and their balance sheets are dominated by financial assets spanning two or more financial 'pillars'. Including estate, trust, and agency (ETA) funds, the nine largest financial conglomerates account for 22 per cent of total financial-sector assets. The five largest have 19 per cent. By way of comparison, the 'big five' chartered banks have 40 per cent of total financial-sector assets if ETA funds are included as being part of sector assets. Although differences in the relative size of these two types of financial institution, namely, financial conglomerates and chartered banks, depend on whether or not ETA and foreign currency assets are included or excluded, their rank order does not change.

Since our financial sector is often described as comprising 'four pillars', another interesting observation about these financial conglomerates is that they account for 75 per cent of the trust and mortgage loan and 21 per cent of the insurance-sector assets. Financial conglomerates have also appeared to rely heavily on takeovers as a vehicle for growth. However, preliminary computations suggest their overall growth rate may be somewhat lower than that of the economy-wide conglomerates.

What does this all mean? Unquestionably, Canadian conglomerates are very large. However, I think that the discussion in the financial press has tended to exaggerate the extent of their holdings, because it has tended to focus on the TSE 300 rather than the economy as a whole.

First, in developing a meaningful estimate of the relative size of conglomerate holdings in Canada, it must be recognized that the TSE 300 is not a proxy for total Canadian business, as has been implied in the majority of press reports. All the reported figures have neglected the substantial assets that do not show up in the TSE 300 index. The TSE 300-based estimates do not take into consideration the sum of the assets of Canadian companies listed on other Canadian exchanges but not on the TSE or of companies listed on the TSE but omitted from the 300 index. As well, the assets of private corporations have been omitted. Also excluded are the assets of foreign subsidiaries not listed on the TSE and the sizeable assets of our Crown corporations.

Taken together, the order of magnitude of the additional assets that should be included in the total domestic asset denominator is such that the major economy-wide conglomerates' ownership control of the country's total assets would likely be less than 20 per cent, while the

above list of financial conglomerates would have ownership control of less than 10 per cent of total assets. Clearly, the presence of conglomerates in the economy is very significant, but it appears to be less extensive than has been suggested.

CONGLOMERATES: GOOD, BAD, OR INDIFFERENT?

So far, all we can say about conglomerates is that they are big, but not as big or as dominant in the economy as has been suggested. The critical questions relate to the effects of conglomerates. In particular, do they contribute to or detract from the efficiency of the economy? What is the least restrictive regulatory regime for the control of potential problems with mixed financial and nonfinancial conglomerates?

I think that an unbiased reader of the academic literature, research, and political studies of conglomerates in Canada and abroad would conclude that no strong evidence has been assembled that could lead to a definitive conclusion that conglomerates are either inherently more or less efficient than other firms. Indeed, the record would suggest that, as with most organizational forms (depending on the competitive situation, the quality of management, and other factors), they can be *either* better *or* worse.

Conglomerates are not new to Canada. While their existence creates unease in the minds of some people, there is little concrete evidence of particular behavioural or performance problems associated with this form of organizational structure. The only clear conclusion about conglomerates is that no simple generalizations can be made.

In this situation, we have to ask whether policy makers should, *a priori*, rule out or limit the potential gains in efficiency that might accrue to the market from this organizational form. Given the potential for loss to the economy, it would seem reasonable to focus the policy discussion on the potential problems to determine whether they can be adequately addressed. If potential problems can be addressed, then rigid restrictions would not be necessary. The Green Paper has identified two potential problems: self-dealing and conflicts of interest. I would like to address them now.

Self-dealing and its effect on the stability of the financial system

One concern about the prevalence of large closely-held financial conglomerates relates to fears about their potential effect on system stability and institutional solvency. This view seems largely to be based on the fact that in recent years shareholder self-dealing has contributed to the failure of a number of financial institutions. The *Interim Report of the Ontario Task Force on Financial Institutions* (1984) reported that there have been twenty-five such failures since 1964. These failures range from large firms such as Atlantic Acceptance to small mortgage brokers.

In this context, the essential question for system stability would appear to be the investor's perception of the adequacy of the legal and regulatory regime to ensure that fraud and improper transactions do not take place on a system-wide basis. Arguably, the recent problems with the Ohio Saving banks revealed that the US system for monitoring the pledging of assets as collateral is inadequate and that the private deposit insurance system in Ohio was not adequate. The former matter could logically cause a flight of capital as investors reassess the risk of leaving funds in US institutions. Conversely, the failure of a local bank or trust company as a result of a slump in the local economy should have less potential contagion and instability effects.

In the present debate about conglomerates and system stability, the relevant question would appear to be: can adequate methods be devised to provide investors with a high degree of confidence that self-dealing within the conglomerate that has their funds will not expose the investor to abuse, and will not noticeably increase the risk of insolvency for financial institutions? This issue can be examined only by looking at the particular policy options for addressing self-dealing. To the extent that the existence of deposit insurance protects small investors and hence most of the participants in the system, the stability issue will be associated with movements of larger blocks of funds by institutional investors.

The problem of self-dealing or non-arm's-length transactions (NALTs) can be described in the following manner. In arm's-length transactions, the opposing interests of the two parties to a transaction can be relied on to ensure a reasonable probability of fair deals. In self-dealing situations, where the same individual is engaged in both sides of the deal, there is a risk that the decision can be biased to

favour the influential party at the expense of the corporation and the interests of affected third parties such as minority shareholders, depositors, or owners of administered trusts.

Policies for the control of self-dealing

It is important to keep in mind that the issue is not self-dealing per se, but the potential for abuse in self-dealing situations. To prevent abuses from occurring, there are three generic options: self-dealing transactions could be prevented from arising through ownership rules such as those embodied in Canadian banking legislation; the potentially offending transactions could be banned; or methods could be devised that would allow those transactions to proceed where assurance can be provided that abuses cannot occur within the institutions.

I think that we should seek ways and means that are least restrictive of competition to ensure that a particular transaction involving self-dealing does not produce abuse. In any business transaction, there inevitably is a degree of risk and uncertainty surrounding the quality and completeness of the information and the analysis available to the decision-makers and to the regulatory regime. Similarly, forecasts of future revenues and changes in the economic environment that affect the transaction involved are inevitably matters of judgement. The extent of this uncertainty and risk can vary widely between deals. At one extreme, a simple transaction involving a Canadian Treasury bill would typically involve relatively little uncertainty. At the other, complex acquisitions of major firms or large blocks of real estate would have inherently more uncertainty. Consequently, any system of control that allows some deals to proceed will have to be based either on business judgement or on rigid regulation of eligible transactions.

I think we all recognize that while there would be advantages to a general ban on NALTs, there would also be drawbacks. Many self-dealing situations can in fact contribute to the efficiency of our financial markets and the economy. The ability to allocate funds internally between the various diversified corporate arms within a conglomerate can be desirable, in that assets can be readily shifted to their most productive use and risk can be better managed. Other common examples include modern merchant and investment banking, which often sees the investor placing both equity and debt in a firm. A

ban on self-dealing within a financial conglomerate would make these activities impossible.

Concerns have also been raised that if the trend toward financial conglomeration by groups with significant non-financial-sector interests continues, the financial institutions that are part of such groups would have the business activities and investment choices available to them and the trust, pension, or mutual funds they manage made even more limited under a general ban on non-arm's-length transactions. To the extent that the small number of large integrated financial and nonfinancial conglomerates is perceived to be a concern, a ban on self-dealing may tend to force them into tighter financial relationships with each other. Lastly, there is no guarantee that an uncompromising ban on self-dealing would be effective in deterring unscrupulous or fraudulent individuals from involving third parties in transactions in ways that would ensure that the technical features of a ban were maintained while the effect was otherwise.

For these reasons, I think that consideration should be given to whether laws, regulations, and procedures could be developed to address the basic issue of the nature and quality of the decisions that underlie self-dealing transactions. Such a mechanism should focus the minds and energies of the business community on avoiding abuses of self-dealing. This could involve a detailed system of NALTs review by a committee of directors independent of the transaction. Appropriate legislative amendment could be enacted to establish that the members of the committee, when active in that capacity, owe a duty of care not only to the financial institution, but also to its depositors, policy holders, and certificate holders. Legal sanctions would be required in respect of the committee members' duty of care to the public to ensure that the persons charged with the responsibility for reviewing these transactions hold this responsibility in earnest. An express duty more onerous than that found in modern corporate statutes such as the Canadian Business Corporations Act (CBCA) would need to be prescribed. Also, additional intracorporate and regulatory monitoring would be required and special provisions implemented for redress, enforcement, and penalties. In this context, the Green Paper's proposal for discussion concerning the possible establishment of a financial conflicts-of-interest office could be used to assist individuals who may have been abused in a self-dealing

transaction so that they are not faced with an unequal contest in their efforts to seek redress.

With such a system, arm's-length transactions could be approximated, and third parties and regulators would be provided with a high degree of assurance that the deals were being done at fair market value when consideration is given to all factors associated with the individual transactions. If the appropriate legislation is enacted, a reasonable and proper balance could be struck between the objectives of solvency and economic efficiency. While regulatory convenience would seem to favour a self-dealing prohibition, it is my view that the benefits of competition and economic efficiency suggest careful review of an option that would rely on implementing procedures to screen non-arm's-length transactions and allow those that are just and reasonable to proceed.

Conflicts of interest and the Chinese Wall

I would like to turn now to the related issue of conflicts of interest and its regulation. At the outset, I would like to state that I agree with the position in the Green Paper that Chinese Walls can be used effectively to control abuse of conflicts of interest. My reason for wishing to discuss them is to point out that once an adequate legal and administrative regime is in place to deal with conflicts of interest, these Chinese Walls may well represent a procedure that would allow, for example, trust companies unfettered commercial lending with the least regulatory burden and in a manner that is least restrictive of competition. This leads me to conclude that careful consideration should be given either to allowing financial companies to choose this organization and regulatory approach or to eliminating some of the restrictions in the basket clauses altogether.

One of the rationales for restricting the line of business of firms in the financial industry is the belief that separation of financial functions is necessary and justified to regulate for solvency and for the control of conflict-of-interest abuses. Clearly, a number of conflicts may arise if financial institutions carry on different activities. The most-cited example is the conflicts that can occur when fiduciary and commercial lending activities are allowed to co-mingle. In such situations, a basic conflict will arise when the institution, in the course of its commercial lending activities, obtains material inside information about a commercial customer. The institution owes a duty

to its commercial customer, at common law, and to the public under relevant securities legislation, not to disclose such confidential information.

However, the institution owes fiduciary obligations to its trust customers and may possibly be in breach of its obligations if it does not use the information that it possesses for their benefit. The institution may thus incur a liability if it discloses the information to its trust customers, but it may also be liable if it does not disclose it. Further, if a financial institution has lent money to a commercial customer, it has its own interests at stake. If the institution also carries on trust activities, it may find itself in a position where it may be in the interests of the institution to make trust fund investments in its commercial customer in order to protect its outstanding loans.

It is worth noting that the potential for abuse of conflict of interest currently exists within the 7 per cent basket clause. To the extent that the trust industry has been able to deal with the problem, ad hoc solutions must exist. Indeed, the obvious conflict of interest that securities underwriters face when giving investment advice to a client is an example of how rules, regulations, and procedures can be used to manage effectively and limit potential abuses of conflict of interest.

As was noted in the Green Paper, the problems raised by conflict of interest do not tend to be of a nature to threaten the solvency of the institution involved. Notwithstanding this fact, the document reflects the concern that confidence in the system may be diminished by appearances of unfairness or improper use of confidential client information. To address this issue, it has been proposed that Chinese Walls could be created to separate the fiduciary from all other financial operations within an institution and its affiliates under a financial holding company umbrella.

A Chinese Wall is essentially a collection of rules, procedures, and, possibly, physical arrangements designed to prevent communication of information from one division of an institution to another. The most comprehensive legislative and administrative recognition of Chinese Walls has occurred in the United States. The American experience with the walls has clearly indicated that they are very effective in protecting the public interest without imposing excessive burdens on the operations of financial institutions. Further, there is ample evidence that this procedure has worked well in a number of different applications. The Securities and Exchange Commission

(SEC) has endorsed Chinese Wall procedures, supplemented by a restricted list, as an effective technique in preventing the flow of inside information. The New York Stock Exchange has also issued a policy statement requiring the erection of an informal Chinese Wall by member firms that have directors sitting on corporate boards. The codes of the Financial Analysts Federation and the Institute of Chartered Financial Analysts recognize the value of Chinese Wall procedures in ensuring compliance with laws and regulations relating to the use of material, nonpublic information and in ensuring that an analyst's personal transactions do not take priority over or conflict with those made for clients. There is evidence that Chinese Walls work equally well within the banking sector, from both industry and government accounts.

In light of this procedure's impressive track record, I think it has potential for a wide range of applications in Canada. In conjunction with appropriate solvency regulations, it could be employed to allow each type of institution to engage in a broader variety of financial activities within the same corporate entity. This could be a particularly important option for smaller trust and insurance companies, for which the creation of a financial holding company or a Schedule C bank could be quite a burden. Heavier reliance on Chinese Walls could enhance competition among financial institutions, could result in broader access to services for consumers, and could promote greater efficiency within our financial services industry.

SUMMARY AND CONCLUSIONS

I would like to conclude my remarks with some summary comments about the issues I have raised in the paper.

First of all, to my mind, many of the data that have been offered up in the press and elsewhere as proof of bank dominance or the pervasive influence of financial conglomerates in the economy should be seriously questioned. I think it is important that we force the concentration issue into the proper framework before coming to any firm conclusions about the present or predictions about the future. Most of the data on the size of conglomerates and the size of the banks do not tell us much that is useful from the perspective of analysing competition issues except that these firms are large. As I have noted, these conglomerates do not appear to account for as large a proportion of the national economy as is generally implied in the press.

The primary problem with the current public discussion of market power and dominance is that it has been largely conducted in the absence of a rigorous analytic framework. Most of the discussion has focused on aggregate size and ignored the traditional market-based analysis that looks at concentration *within a defined market*. At best, the discussion has focused on data that compare the size of different institutional groups. Any meaningful analysis of actual or potential dominance must begin with the definition of markets, assess the economic and legislative barriers to entry that determine the contestability of these markets and the nature of competition within them, and examine the relative competitive advantages and disadvantages of the various firms in these markets and of potential entrants. To say that none of this work has been done would be an overstatement, but it would not be far off.

Even after the appropriate competitive analysis is done, one still has to ask: so what? Competition is a policy tool that can achieve greater efficiency and effectiveness of our capital markets. If the present regulatory segmentation of Canada's capital markets into separate pillars reduces competition and the effectiveness with which these markets serve Canadian savers and users of capital, then we must ask whether changes are required. Indeed, in this context very careful consideration must be given to the policy goals and the rationale for regulation. In the broadest sense, regulation of capital markets is justified on the grounds of providing a degree of confidence in the solvency of the institutions and of minimizing abuses of conflict of interest. The issue in the present context is the form of regulation that can provide adequate protection in a manner that is least restrictive of competition so that the capital markets can be as efficient as possible.

In this context, the character of the nexus between concentration, competition, and efficiency requires a sophisticated understanding of how these markets operate. For example, concerns about concentration can be readily addressed by policies that facilitate entry. Each time greater bank participation has been allowed in various financial services markets, competition has intensified and the consumer has benefited. We need only look to the changes that have taken place in the consumer lending and residential mortgage markets in the past twenty years for proof.

There is of course the long and well-known list of restrictions associated with the activities of different pillars that have been used to define, for regulatory purposes, the roles of the various players. In this context, I agree with the suggestion in the recent Green Paper that Chinese Walls can be used to overcome conflicts of interest between the ETA business of trust companies and commercial lending. However, more effort should be devoted to examining the extent to which this procedure can be employed to control effectively a wider range of potential conflicts which would make it possible to reduce the current activity restrictions and thus broaden the range of services that could be provided within the same financial institution. This could be a minimal regulatory intervention that would stimulate competition without creating 'major' regulatory burdens. I recognize that this may require a careful reassessment of the rationale for regulating various activities differently, but surely this is the time for that reassessment.

Another major class of legislative barriers to entry is that associated with ownership, both domestic and foreign. At present, there are different foreign ownership restrictions and models operating in the various pillars. All, however, seem to be explained by the notion that the financial sector is a 'key' sector that must remain in Canadian control. The times have changed since these policies were implemented, and the continuing concerns about the ability of our financial markets to deliver the goods quickly, at the lowest cost, and in the right configuration to Canadian industries that need the capital to become internationally competitive suggest that a fundamental review of these policies is essential. The example of the benefits of competition for business borrowers in the middle markets that have followed from the limited participation of the foreign banks suggests that a broader reassessment across the capital markets is warranted. Last year, the House of Commons finance committee studying the situation recommended the removal of foreign ownership restrictions for banking. Instead, the foreign banks were allowed to grow from 8 per cent to 16 per cent of banking assets. The recent OSC ownership review did not re-examine the existing government policy and instead made elaborate recommendations that would allow some additional foreign participation but under a complex and constraining set of regulations. It is time to get back to the basics and ask whether Canada can afford to forgo the benefits of having fuller participation

of international suppliers of capital in our insurance, trust, banking, and securities businesses. For those who worry about the potential for a small number of Canadian conglomerates or the banks to dominate our capital markets, surely the discipline of greater foreign competition should be a key policy option that warrants a full and careful review.

As I have said, the theory and evidence on conglomerates suggest that it would be precipitous to limit arbitrarily their role in the Canadian economy. I would argue that we should be seeking to establish the regulatory regime that will be effective in stopping potential problems in a manner that creates the fewest restrictions on competition.

In this regard, the issue of self-dealing appears to be the most critical. I have argued above that the option put forth for discussion in the Green Paper, which would rely on a ban on self-dealing, would lead to the inability of related or affiliated financial institutions to put together financial packages for users of capital that include significant amounts of both new equity and debt. These problems could be overcome through a self-regulating mechanism that could broaden the fiduciary responsibilities of boards of directors, increase the standard of care imposed on them, and strengthen the regulatory process in order to ensure that where self-dealing does occur, the deals approximate arm's-length transactions.

In summary, I think it is essential that we keep in mind that the role of *all* financial institutions is to facilitate the transfer of funds from savers to borrowers. We must continue to look for ways to make this process of financial intermediation take place as efficiently as possible, while ensuring that institutional solvency and system stability are not compromised.

In this industry, as in many others, it appears that this can be achieved by selecting the policy alternatives that are the least restrictive of competition.

APPENDIX: NOTES ON CONGLOMERATE SIZE IN THE CANADIAN ECONOMY

The purpose of this appendix is to provide further details on the computations presented in the text on the nature and extent of conglomeration in the Canadian economy, with particular reference to the financial sector.

A distinction has been made between two types of conglomerates: economy-wide and financial conglomerates. An economy-wide conglomerate is defined as a group of corporations with operations in three or more two-digit Standard Industrial Classification (SIC) categories of the Canadian economy. A financial conglomerate is similarly defined, with corporate subsidiary operations in two or more financial 'pillars' or sectors. In the case of financial conglomerates, when corporate ownership links span real and financial-sector activity, an attempt has been made to separate and report only the financial asset values.

The paucity of information on conglomerates results in the use of disparate and not always comparable data sources. For example, in some instances, data from Statistics Canada have been used, while in other cases information derived from corporate annual reports is used. Accounting conventions, statistical coverage, and reporting periods (calendar versus fiscal year), as well as voting stock ownership thresholds used to establish intercorporate control links, differ among data sources. These and other drawbacks mentioned below suggest that the estimates present be used cautiously and only for the general purpose of establishing the rough order of magnitude of conglomerate activity in the Canadian economy.

ECONOMY-WIDE CONGLOMERATES

Data on the top twenty-five enterprises are obtained from Statistics Canada, Corporations and Labour Unions Returns Act, Part I, catalogue number 61-210. This publication also indicates the ownership characteristics (foreign, Canadian private, and government) of the leading enterprises. An enterprise is defined as a corporation that has 50 per cent or more of its common voting stock (directly or indirectly) under the control of a single corporate entity or holding company.

The statistics reproduced below relate solely to the nonfinancial sector of the Canadian economy and suggest that aggregate concentration increased between 1980-1 primarily because of the growth of

Canadian private-sector corporations. Much of this growth can be attributed to merger activity. Note the relative decline in the share of sector assets accounted for by government-owned enterprises.

Data on total assets of fifteen specific economy-wide conglomerates mentioned in the text were obtained from individual corporate annual reports. The figures reported are estimated consolidated assets of conglomerates and include financial assets as well. In addition to the criteria mentioned in the main body of the paper, the 20 per cent threshold level of commonly held voting stock was used to determine intercorporate control links. The corporate ownership linkages were established using information collected by Statistics Canada under the Corporate and Labour Unions Return Act (CALURA) and various other sources such as the Financial Post Corporation Service Index Cards. The total assets of each 'controlled' subsidiary were aggregated to denote the amount of assets of the conglomerate or holding company. The estimated total consolidated assets are given below.

FINANCIAL CONGLOMERATES

The criteria used to compile the list of financial conglomerates were that each had 1984 assets in excess of $2 billion and each had activities spanning two or more financial 'pillars'. As in the case of the fifteen economy-wide conglomerates, the intercorporate ownership links of the nine financial conglomerates mentioned specifically in the text were established using the 20 per cent threshold level of commonly held voting stock. The financial assets of each 'controlled' subsidiary were aggregated to denote the total amount of assets of the financial conglomerate.

Given the substantial lags in the publication of official institution-specific data, and the desire for the most up-to-date information, annual reports were used as the primary data source.[1] However, it should be stressed that these data contain a number of shortcomings, stemming mainly from the nature of the consolidated balance sheets published. Lack of detailed data on many individual corporate subsidiaries and on the extent of the conglomerate's international and/or non-financial-sector business often made it impossible to isolate purely *domestic* financial operations.[2] Where major gaps in data exist due to balance sheet consolidation or omissions, the annual reports were supplemented by (preliminary) information obtained from

federal and/or provincial regulatory agencies. In some instances individual companies were approached to obtain the necessary information. The data shortcomings result in overstating the relative size of each conglomerate, as well as the conglomerate share of domestic financial-sector activity.

The fact that conglomerate international business cannot always be isolated should not pose any major problems for purposes of comparing relative sizes of different types of financial institution (i.e., financial conglomerates and chartered banks), provided that the foreign currency assets of the other financial institutions are also included in their asset total.

In Tables 1 to 5, a distinction is made between the inclusion and exclusion of ETA funds. These funds are administered by trust companies under their fiduciary role. The relatively large magnitude of ETA funds (over $100 billion at the end of 1984) and the fact that these funds are substantially larger than trust companies' intermediary-related assets have resulted in their inclusion-exclusion being central to the debate on the relative size of Canadian financial institutions. While the inclusion of ETA funds does not affect the rank order of size of different types of financial institution, the relative size differences between trust and mortgage loan companies and the chartered banks are substantially affected. The distinction with respect to ETA funds is made in the tables purely for illustrative purposes.

At present, data for only 1984 have been compiled. Historical data series on financial conglomerates are in process.

NOTES

1 Note that most annual reports publish a balance sheet that consolidates only a proportion (based on ownership share) of the assets of a subsidiary's assets into the parent company's balance sheet. Because this practice differs substantially from the method used here, total assets for each conglomerate may not necessarily correspond to those published in annual reports.

2 The Crown Life Insurance group of companies, for example, carries on only about 20 per cent of its business in Canada (see 1984 Annual Report, 4) and is involved in a broad range of services, including investment operations, data and computer services, and real estate. Yet the consolidated balance sheet, as published in the annual report, does not reveal this information.

TABLE 1
Nonfinancial sector: leading 25 enterprises – percentages (number)

Year	Foreign	Private	Government	Total	Total sector assets ($ million)
1975	5.4	10.0	13.8	29.2	245,459
	(9)	(12)	(4)	(25)	
1980	5.8	10.0	14.3	30.1	463,698
	(9)	(12)	(4)	(25)	
1981	5.7	16.5	9.9	32.1	536,978
	(9)	(14)	(2)	(25)	

SOURCE: Statistics Canada, Cat. No. 610, Part I, 1975, 1981.

TABLE 2
Total consolidated assets of fifteen largest economy-wide conglomerates ($ billion)

1980	1981	1982	1983
89.1	116.7	126.2	155.0

NOTE: See text for further details.

TABLE 3
Distribution of financial-sector assets 1984 (percentage)

Institution	Total assets		Total domestic assets[a]	
	with ETA[b]	without ETA	with ETA[b]	without ETA
Chartered banks	42.9	49.0	27.9	33.2
Mortgage loan companies assoc. with banks	4.1	4.7	5.3	6.3
Subtotal	47.0	53.7	33.2	39.4
Trust and other mortgage loan companies[c]	20.1	8.8	26.8	11.7
Credit unions and caisses populaires	4.8	5.5	6.2	7.4
Total life insurance[d]	10.7	12.2	10.4	12.4
Other financial institutions[e]	17.3	19.8	24.4	17.3
Total ($ billion)	862	755	673	566

a Excludes foreign currency assets and assets of foreign subsidiaries.
b Enabling legislation empowers only trust companies to hold ETA funds. Inclusion of ETA for these institutions, however, alters the percentage share of total financial-sector assets held by each type of institution.
c Includes trust company retirement savings funds.
d Includes segregated funds of life insurers as well as accident and sickness branches of life insurance companies.
e Includes financial corporations, financial leasing corporations, business financing corporations, real estate investment trusts, closed end funds, property and casualty insurers, investment dealers, investment funds, quebec savings banks, and trusteed pension funds,
SOURCES: *Bank of Canada Review*; *Financial Institutions*, Statistics Canada, Cat. No. 61-006; *Financial Flow Accounts*, Statistics Canada, Cat. No. 13-002.

TABLE 4

Largest financial conglomerates versus largest chartered banks (1984)

	Assets, including ETA		Assets, excluding ETA	
	$ billions	% of total	$ billions	% of total
'Big five' banks[a]	344.15	(40)	344.15	(46)
'Big five' FHCs[b]	162.21	(19)	66.47	(9)
Total financial sector assets	862.59	(100)	755.4	(100)

a Includes wholly owned subsidiaries and foreign currency assets.
b Includes in descending order of size: Trilon Financial Corporation, Power Financial Corporation, E.L. Financial Corporation, Desjardins Group, and Genstar Financial Corporation.
SOURCES: Annual Reports; *Financial Institutions*, Statistics Canada, Cat. No. 61-006; *Canada Gazette*, Part I; *Bank of Canada Review; Financial Flow Accounts*, Statistics Canada, Cat. No. 13-002.

TABLE 5

Conglomerate assets ($billion) and sector share (%) in insurance and trust and mortgage loan industries (1984)

	Including ETA	Excluding ETA
Total conglomerate assets	188	87
in TML	132	38[a]
in insurance	24	24
Other	32	25
Total TML-sector assets[b]	175	66
Conglomerate share of TML-sector assets[c]	75%	58%
Total insurance-sector assets[d]	113	113
Conglomerate share of insurance industry assets[c]	21%	21%

a Includes some ETA funds for smaller companies that could not be isolated.
b Includes trust company retirement savings funds.
c Note that the figures are somewhat upward-biased because conglomerate data (the numerator) were obtained from annual reports and include some nonfinancial and international subsidiary data, whereas the industry-wide total assets (denominator) are taken from *Financial Institutions*, Statistics Canada, which excludes nonfinancial and subsidiary data.
d Total insurance industry assets are defined to include assets of life insurers, life insurers' accident and sickness branches, segregated funds offered by life insurers and fraternal benefit societies, and property and casualty insurers.
SOURCES: Annual reports; *Financial Institutions*, Statistics Canada, Cat. No. 61-006.

Consequences of deregulation

Thomas Kierans

INTRODUCTION

I want to focus on the consequences of regulation. Regulation is the enhancement of countervailing powers, for better or for worse, that affect the free workings of the market economy. Enhancement of countervailing powers can involve the state intervening directly at the expense of the market, or alternatively the assignment or implicit acknowledgment by the state of the right of industry bodies to self-regulation. The state may accord them *de facto* or *de jure* powers which they would not otherwise have, and, in my rather cynical view, it simply involves granting them a licence to extract rents.

We hear a lot about solvency, and my own judgement is that it is trite to reiterate over and over again the desirability of such intervention, or intervening factors. Obviously solvency, the restriction of self-dealing, the enhancement of consumer protection, and, as Lawson Hunter has discussed, system stability or maintaining that crucial sense of the integrity of the system are essential to the effective and efficacious working of it. Almost everybody pays lip service to those attributes.

The essence of the debate going on in Canada today, however, is the extent to which such barriers unnecessarily impede the advantages associated with the workings of the free market economy. In other words, to what extent is the efficiency trade-off excessive? Therein lies the rub, for once we begin to talk about deregulation or re-regulation, or implementing a lighter hand of regulation, we have

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emerging immediately the established vested interests. They come into play, subtly or bluntly, to protect those interests, to protect the licences that grant the rents, and to maintain their established positions behind the walls of regulation, which in the final analysis constitute barriers to change.

My favourite recent example is the Public Service Alliance getting involved in the deregulation of airlines and raising the bugaboo of safety restrictions. It is quite clear in this instance that labour is seeking to preserve its share of the rents being extracted at the expense of the consumer. Similar examples apply equally across the financial spectrum as well.

I think we have to understand whence we are coming. This country stands at the threshold of change, not because we chose it, not because we seek it, but because it is being thrust upon us. Our trade position, for example, is eroding. Our place at the 'cutting edge' of technological innovation is certainly debatable. Our chief trading partners, the United States and the United Kingdom, have made enormous commitments to opening their economies to the vagaries associated with change. For those reasons, I believe that we should, in a determined but responsible fashion, strengthen the market, at the expense of the state, as the best means of promoting efficiency of change. Efficient change constitutes the *sine qua non* of effective adjustment.

Against that angle of perception, how does one assess the responses to the tentative steps taken in Canada thus far to promote change in the conduct and in the regulation of our financial system? Thus far the debate has been dominated by those who are buffeted by the strains in international credit systems and therefore defensive. Others, beset by the deteriorating financial position of the Canadian domestic economy, are equally defensive. For these understandable reasons these groups are resisting attempts to recalibrate the system, to enhance the influence of the market, to recognize the onslaught of international developments and technological innovation, and in short to promote the process of change.

Of course, the recalcitrants are raising fears as to what might happen 'if' – the 'what if?' syndrome. It is a very effective kind of response. But in Canada we have a broad public commitment to a mixed economy, and in that environment public understanding of the attributes of the market economy is less than it might otherwise be. It certainly is less pronounced than in the United States.

I tend to think of Canada as being wafer-thin. The long-standing and generally successful partnership between the state and the private sector has been mandated by our geography and by the struggle for independence from our more cohesive neighbours, whose economy achieved a critical mass long before ours. We feel, too, that the centre should encourage the artificial east-west integration of a far-flung string of communities. In that context, the 'what if' syndrome is a potent way of resisting change. We have two great national myths. The first is that the regular hockey season is as good as international league play. The second is that in our decidedly mixed economy the partnership of the state and the private sector does not need periodic cleanings to prevent hardening of the arteries.

With that somewhat hyperbolic introduction, let me turn now to the Green Paper on the regulation of Canadian financial institutions.

THE GREEN PAPER

Let us examine what the Green Paper is. First, it is in my judgement, a serious attempt to promote competition and to liberalize. It is also a serious attempt to update the legislative and regulatory framework covering some financial institutions that have not been examined for many decades. Secondly, it is an ambitious attempt to re-regulate, to curb excesses, and to label clearly some of the frauds that have rocked our financial system at a particularly bad time.

The Green Paper promotes competition. First, it unlocks the latent power of the massive mutual life companies. I think that the opportunities for these new players to be introduced in a more diversified sense into the economy, into the financial institutional structure, can provide nothing but beneficial developments.

Second, for better of for worse, but as an end in itself, it lays to rest the long-standing bugaboo about trust companies and trust and mortgage company ownership. I think that continuing to argue about that, or to try and close the door after the horse has bolted, is clearly an impediment to change and to getting on with the job. Also, it invites the financial conglomerates and what Lawson Hunter calls the economy-wide conglomerates to enter the game. As Hunter has indicated, there is a lot of concern, probably well placed, about the power of these conglomerates, but we must look not for the symptoms of the problem, but for its causes. In economic theory there is nothing

wrong with conglomerates of a financial or otherwise nature. The contestability of markets is what counts.

To the extent that the concentration of power and the growth of conglomerates in Canada are a problem, it is because our markets are not contestable. If this is true, it is because our economy is not open, for whatever reason: our volatile exchange rate, foreign-exchange investment restrictions, or any number of other reasons. But that is how one assesses the issue of concentration of power. With conglomerates, one does not say off the cuff, without any kind of research, that because they are there and because these numbers are being thrown around about the influence of these types of institutions – without supporting research – therefore they will not be allowed into the reorganization. I think that the Green Paper makes a positive and meaningful contribution there.

I think the Green Paper conceptually takes on some other interesting factors. It does away with the barriers of entry posed by the outdated separation of pillars, which helps to preserve the status quo. It explodes the myth of the four pillars, which is not representative of what our system has been, much less what it is going to be in the not-too-distant future.

I think that the Green Paper also offers a hope of survival to the regional Schedule A banks. In this sense, I think that the 'big five' missed the mark in some of the criticism put forward by the Canadian Bankers' Association. The regionals are not there to provide competition for the 'big five' or the 'big six'. They are there essentially because the culture and the ethic of our country say, particularly in western Canada and in Quebec's caisse system, that there is a profound mistrust of the centralized chartered bank system. People feel the need to identify regionally. Those banks ought to survive not for economic but for cultural reasons. The Green Paper, by raising the possibility of Schedule C banks, provides them with the wherewithal and the means to do so.

However, I think that it was a mistake to bring down a Green Paper without having dealt with the issue of deposit insurance. Deposit insurance is a fundamental economic principle associated with financial institutions in Canada, and if one is reorganized, they both must be.

The Green Paper does not deal with the chartered banking system, and to recalibrate, re-regulate, and reconceptualize the financial industry in Canada without that cornerstone is a problem. A premature

Schedule A Bank Act revision would have put the whole thing off for four or five years. While there are large numbers of bodies in Ottawa, talent is strictly limited, and there are just so many people available to put to work on that thing. Much as this might pain Ontario bankers, if these changes are going to give the system a five-year head start, or a four-year head start, I am not at all certain that it is the end of the world.

The Green Paper may have negated the efficacy of the Schedule C concept right off the top. As Lawson Hunter has said, self-dealing is not fraudulent or wrong. I am not at all certain why anyone would want to have a Schedule C bank, because of what I would regard as an excessive concern with the self-dealing problem. I think that other approaches could be developed to deal with it.

Perhaps the most telling criticism I have of the Green Paper is that it is a direct slap at this new government's approach to federal-provincial relations. This government did not get elected to grab powers, as in the National Energy Program, and this Green Paper looks like that kind of power grab. Nowhere in it is another model seriously discussed or analysed for the purpose of developing expanded commercial lending powers. It is quite clear that the federal government is taking the view that if there is to be any expansion of commercial lending powers, it will be under the federal government's jurisdiction and agency. I frankly regard that as a mistake. I regard it as counterproductive.

Finally, I regret that the Green Paper did not adequately address the foreign ownership issue. Basically, there is a matrix there. Somebody recognized at the end of the day that they had not dealt with nationalism and foreign ownership, and so somebody stuck this section in so that they could send it to the printer. I agree with Lawson Hunter that it is time to get back to basics.

In my own industry, there is no academic evidence about whether this industry constitutes part of the high ground of control that has to be preserved. I think that it is a pity that the Green Paper did not examine that issue.

CONCLUSION

First, I regard the Green Paper as a worthy beginning effort. Second, I regard many of the criticisms that are coming out, the 'what if?' criticisms, as lacking substance, both theoretical and practical. They

are very self-serving: they are saying, let's not change because we can't foresee the consequences. What that has to do with a market economy in a period of pervasive change I really do not know.

Third, we are forgetting that many of these developments have taken place at a bad time. Not all the problems within the financial system in Canada and the United States are due to fraud or to inadequate regulation. There are very serious economic problems that have exacerbated these issues gravely. If our chartered banking system had not become over-exposed internationally and (within inflationary environments) to commodities within the Canadian economy, many 'what if?' problems could be looked at in a different perspective.

Fourth, I think that concentrating on yesterday's problems ignores the capacity of the system to regenerate itself without government direction. Typically, these problems go in cycles, and it is not likely that bankers, or conglomeraters, or acquisition experts will make the same mistakes for the next decade that they made over the last four or five years. The system is self-regenerating. There is an essential integrity to the Canadian system, Greymac and Rosenberg notwithstanding. Most Canadians pay their taxes, and so we collect taxes almost on a kind of honour system. That constitutes a large part of our financial system as well.

Finally, I think that conflicts are a fact of life. I think that the four pillars are a silly way of dealing with conflicts. Conflicts are there; they will always be there regardless of what kind of financial system you have. It is how you deal with them that counts. Seeking excessively to constrain change within the system is, in my judgement, not a good approach.

Discussion

JOHN EVANS: At one time I was chairman of the House of Commons finance committee that looked into Schedule B banks. I agree very much with what Lawson Hunter has said. I agree with most of what Tom Kierans has said, but I differ fundamentally on certain points. One of the points is that the Green Paper promotes competition. I think that it does just the opposite, quite frankly. The self-dealing prohibitions (I think Tom raised that as a caveat) certainly will constrain institutions in a great many areas.

The Green Paper tightens up rather than relaxes the participation of foreign-owned institutions. For financial holding companies, foreign-owned trust and life insurance companies are being discriminated against in a way that they never have been in the past. The paper refuses to deal with the powers of specific institutions, such as the expansion of powers of trust companies or life insurance companies. In the mutual area we do not know what Ottawa is going to do; there is only one paragraph that mentions a possibility of downstream holding companies. But can those downstream holding subsidiaries hold Schedule C banks, for example? If they can, we have opened up a whole range of other problems.

The Green Paper refuses to deal with the merchant banking and the equity funding problems that this country faces. Mr Kierans has mentioned that the Green Paper recognizes conglomerates. Well, they are already here, and the Green Paper constrains their powers. If they are a competitive force, the Green Paper's proposal will simply tighten up control over conglomerates and refuse them the kind of synergy that they are benefitting from right now, and that has probably contributed greatly to their growth.

Finally, I hear time and time again about self-dealing and the problems of self-dealing. I have never seen evidence to indicate what proportion of the problems of financial institutions in the past five to ten years has been brought about specifically as a result of self-dealing. Self-dealing often arises in the death-throes of an institution. When managers are trying to save the institution from going under, they may do something that they otherwise would not do. But a basic economic problem such as the decline of the mortgage market in the West, for example, may really have caused the problem in the institution. I would like to see some hard evidence as to precisely

where self-dealing has created major problems, apart from the anecdotal evidence about Rosenberg, which may really have arisen as a result of the Ontario government's trying to save rent control.

I am not at all clear as to where all this leaves us. But I am not happy at all, from an economist's point of view, in promoting competition and efficiency with the kinds of measures put forward in that Green Paper. I think we have a long way to go before any of that material is going to find its way into legislation.

TOM KIERANS: First of all, John, I agree with a lot of your comments. What I tried to say in my remarks is that I believe the genuine tenor of the Green Paper was to promote competition. I completely agree that the self-dealing prohibitions are counter-productive to that particular intent. I think that will probably get fixed up, but I accept that point.

Second, insofar as the life companies are concerned, I agree that there are only a couple of paragraphs on them. But there is a model in the province of Quebec, through Bill 75, in terms of the downstream holding company and how that kind of institution could develop competition through the ownership of a Schedule C bank. I think the real problem here comes with the fact that that model may not be applicable in that particularly important province because of the mistaken emphasis that Ottawa has put on federal regulation as opposed to provincial regulation.

Insofar as Canadian investment banks are concerned, I guess that the feds, in deciding that they didn't want to pick a fight with the provinces, left out the investment banks. But they took on a real fight when they decided that they were going to regulate any kind of expansion of commercial lending.

LAWSON HUNTER: What I'm worried about is that the provinces tend to be very much concerned about solvency and self-dealing, and less so about efficiency. If that is so, and if perhaps the federal paper is an attempt to try and deal with those issues so that we don't get into a battle between the two jurisdictions, it strikes me that we are going in different directions. I like the Green Paper for emphasizing competition. But this notion that we have to bring the whole system together, federally and provincially, worries me as an ideal solution. I'm afraid that that will really force us into many more restrictive controls on self-dealing and on solvency, and we will not have any of

the benefits of competition. So if the federal proposal can go minimally in that direction, and at the same time open up some of those possibilities, it strikes me as a big step forward.

TOM KIERANS: I think Lawson Hunter has really put his finger on it, because I think that, with the exception of Quebec, the provinces are much more concerned with the issues of solvency and self-dealing than they are with efficiency and competition. I regard Ontario as the worst offender in the area that Lawson Hunter is talking about.

CHARLES FREEDMAN: John Chant's discussion and framework helped me understand the puzzle that I was worrying about yesterday evening. Right through yesterday afternoon everyone was talking about the movement to deregulation in Quebec. However, in his luncheon address, Jacques Parizeau kept talking about re-regulation, and this morning's *Globe and Mail* quoted him as wanting tighter controls. Now what is it that some of the speakers yesterday afternoon saw that I didn't and vice versa? John's framework may be helpful in interpreting the movement to expanded powers for regulations in Quebec.

If I read them correctly, developments in Quebec are moving the regulators away from the rules category and into the discretion category. What Parizeau said, as I understand it, is that supervisors are going to be given more discretion and are going to be much tighter in administering the supervising regulations and the institutions. Why is it that people focus on the legislative changes and not on the increase in supervision? If I were cynical, which according to my comments yesterday morning I am clearly not, I would say, along with Ed Kane, that the people in the industry think that they are going to capture the supervisors. Not being cynical, I have to conclude that they have not paid any attention to the other half of what Parizeau is saying. The penny will drop later when they realize that the supervision is actually tighter, and I think that Chant's framework is quite helpful in trying to pull apart the two aspects of what is happening in Quebec. But the notion that this is the great deregulation may well end up being a myth.

PART VII: INSOLVENCIES AND PROBLEMS IN DEPOSIT INSURANCE

Insolvencies of financial institutions and problems of deposit insurance

Richard Humphrys

INTRODUCTION

Since this topic relates to deposit insurance, I will confine my remarks to matters relevant to deposit-taking institutions. Of course, many of the remarks and considerations about solvency will apply to insurance companies as well, but that will not be my main focus.

It is not possible to discuss deposit insurance without discussing the regulatory environment in which such a plan is to operate and without discussing the circumstances leading to the determination of insolvency for an institution covered by the plan.

The regulatory environment is vital, since almost everything done under that head affects the risk undertaken by the deposit insurance plan when it guarantees some portion of the deposit liabilities of a regulated institution. Who gets into the field, initial capital requirements, ongoing financial standards, investing and lending powers, the general field of activity, inspection procedures, and disciplinary actions available are all relevant to the determination of the risk.

The determination of insolvency for a financial institution is, of course, vital for a deposit insurance plan, since this marks the point at which a claim arises. The determination of such insolvency is not an easy or straightforward matter capable of easy decision on an objective basis. The relevant definitions under the Winding-up Act, which (rather than the Bankruptcy Act) deals with insolvencies of financial

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institutions, are that a company is deemed to be insolvent if it ceases to pay its obligations as they fall due or displays a financial statement showing its inability to meet its obligations. Neither definition is satisfactory for determining insolvency of a financial institution. As is well known, such an institution can go on meeting its obligations as they fall due long after its financial position has deteriorated to the point of rendering it highly improbable that there will be enough resources to meet all its liabilities. Also, a valid financial statement can be presented that will show a positive shareholder's equity, but if circumstances are such that the assets have to be realized in a hurry, the difference between the carrying value on the balance sheet as a going concern and the realizable value when they are placed on the market may be such that the institution will not in fact be able to meet all its obligations. In the light of the above considerations, it seems essential to discuss the regulatory environment and the criteria to be used for determining when a deposit institution must cease operations before discussing in any detail the design and operation of a plan of deposit insurance.

Since a plan of deposit insurance must be compulsory on a large sector if not the whole of the deposit-taking industry, the situation created by the regulatory system must in effect substitute for underwriting standards that are used in a normal kind of insurance operation. The compulsory requirement leaves the deposit insurance plan without the ability to exercise underwriting judgement in accepting or rejecting a risk except possibly to a limited extent in a divided jurisdiction.

The matter is more complicated, of course, as in the existing plan, where a federally controlled insurance plan offers to insure provincial institutions on a discretionary basis. In such cases, the administration of the deposit insurance plan can and should exercise underwriting judgement in order to be satisfied that the financial standards being used by the provincial jurisdiction are such as to limit the risk to the same general level as is undertaken in the case of federal institutions.

The above considerations make it important to note that the design and operation of the regulatory system must recognize that deposit insurance exists and so must set standards high enough and follow sufficiently rigorous procedures of supervision and discipline to protect the deposit insurance plan from excessive loss and those who must finance the plan from excessive costs. It would be most inequitable to

think of deposit insurance as a substitute for good financial standards and sound procedures.

In fact, a plan of deposit insurance must be considered as an ultimate safety net to deal with cases that fail despite the regulatory network. It can be successful only in an environment of strong and effective regulation that can keep losses few in number and mild in severity.

The importance of the regulatory environment is not confined to the incorporation and licensing of companies and the initial acceptance of the risk under the deposit insurance plan. Under current circumstances, there is no power under the deposit insurance administration to apply any disciplinary measures on member institutions. Instead, this is left to the regulatory authority, be it federal or provincial. The only lever available to the deposit insurance administration is cancellation of the insurance or application for a winding-up order. In fact, however, the power to cancel insurance coverage is not a useful tool unless it were to be accompanied by the power to freeze assets of the institution concerned and apply for a winding-up order. It would be a rare case where a company could successfully carry on after its deposit insurance had been cancelled. Even if it did, there would almost certainly be a run on the company, and if the company ultimately failed, such a run would give an unfair advantage to certain depositors who could get their money out compared with others who held term deposits. As a practical matter, therefore, the only discipline available to the deposit insurance administration is application for a winding-up order, and presumably this would have to go forward with the support and co-operation of the relevant regulatory authority. Otherwise, a court may be rather hard to convince that the issuing of a winding-up order is in fact justified.

This circumstance points again to the importance of the regulatory environment and, in particular, the disciplinary measures available to and used by the regulators where companies get into difficulty. It also emphasizes the point that the deposit insurance plan must be considered as an adjunct to the general regulatory system and not as a substitute for it.

I propose therefore to discuss briefly the significant areas of government action in the regulation of financial institutions for the protection of depositors, indicating where I think the existing system needs to be strengthened or revised, and after this to discuss the

operation of the deposit insurance plan as the ultimate guarantee for cases that fall through the regulatory net.

Some may take the view that it is essentially unsound to establish a plan of deposit insurance to be financed by levies on the industry but to give the administration of that plan and its member institutions no voice in the nature of the risk that the plan is required to undertake. It may be that there is a case for greater liaison between the administration of the deposit insurance plan and the insured members than has occurred in the past, but, unless the regulatory system should become quite ineffective, a deposit insurance plan should never play more than a minor role in the regulation of financial institutions. As such, it would seem to be inappropriate to give it any dominant position in the normal incorporation, licensing, and supervision of a financial institution. The member institutions have ample opportunity to present their views to governmental authorities relative to the regulatory system, and it seems that that is where the corrective measures must be taken if it appears that the risk insured by the deposit insurance plan is becoming excessive.

REGULATORY ENVIRONMENT

Looking then at governmental action for the protection of consumers in relation to financial institutions of the type I am discussing, we have to consider four aspects, namely:

- Formation of companies.
- Corporate powers and financial standards.
- Disclosure.
- Disciplinary powers.

Formation of new companies

The requirements and procedures for obtaining a new charter are relevant for the reason that, for financial institutions, the granting of a charter is still a matter of discretion with the responsible minister. For federal legislation, the minister is the minister of finance together with the Governor-in-Council in the case of banks and together with the minister of consumer and corporate affairs in the case of trust, loan, and insurance companies. This is in contrast to general cor-

porate law which considers incorporation as a matter of right and requires only the filing of articles of incorporation to form a company.

Because the grant of a new charter is a matter of discretion with the responsible minister, the opportunity is created to examine the proposal from the point of view of initial financing, proposed operating plans and forecasts, and (the important and also the most difficult matter) the character and fitness of the incorporators, the principal shareholders, and the day-to-day management.

Questions of initial financing, operating plans, forecast of business development and even management experience are capable of reasonably objective examination. In practice, such matters are carefully studied and charters are not granted unless it appears that the proposed enterprise has a chance of success in the light of considerations under these heads.

The matter of character and fitness of controlling shareholders, directors, and management is more difficult. It is certainly important that the owners and the decision makers in a financial institution be persons of appropriate character and fitness. Efforts are in fact made to see that this is so: references are obtained, business and financial records are examined to the extent available, and judgements are attempted. Extreme cases of course are not difficult, but the range of cases in between is not at all easy to deal with. It is usually not difficult to form a subjective judgement, but it is another thing to deny a charter to an incorporator or group of incorporators on the grounds that in the opinion of a bureaucrat or even a minister the persons concerned are not trustworthy. All kinds of questions arise in this context, such as personal bias on the part of the bureaucrat or minister, political influence, and just plain bad judgement. There is nothing specific in the law giving authority to act on the basis of judgements in this connection, and it has generally been felt that the discretion in the granting of a charter is aimed principally toward the financial base and the operating plan. Character and fitness may be taken into account in the extreme cases but probably not in borderline cases.

It may well be that, notwithstanding the difficulty of making judgements under this head and the possibility of personal bias, the question of the character and fitness of proposed incorporators and owners should receive much more prominent attention. Some jurisdictions in fact give the supervisory authority power to direct a

company to remove an officer or director if that authority arrives at the view that such a person is not of appropriate character and fitness to occupy the post in question. Long experience with the application of regulatory requirements has convinced me that no amount of regulation under financial standards established by legislation can be an adequate substitute for general trustworthiness of the persons making decisions in a financial institution. In fact, financial standards and regulation generally tend to follow the practices devised and adopted by well-run companies. I think therefore that the protection of the public indicates that more specific power should be given to the regulators, bureaucrat or minister, to reject an application for a new charter on the basis of regulatory judgement concerning the character and fitness of the persons concerned. This may seem to some as judgement without trial, and I recognize the difficulties. Nevertheless, it may well be that there is no option.

A further important point in this connection is transfer of ownership. It is not consistent to take great care over questions of character and fitness and operating plans at the outset of a company and then to have no control whatever over sale of the company to new owners who may have quite different operating plans – including a plan to strip the company. Thus, control of transfer of ownership is essential, together with a re-examination of authorized borrowing ratios where control changes.

Some jurisdictions have a further requirement before a charter is granted, namely, to be satisfied that there is need for an additional institution to operate along the lines outlined in the development plan. This is another requirement that might be considered as part of an appropriate statute, but it seems to be principally a matter of a business judgement, and if the proposed incorporators are prepared to take the risk and have adequate financing to bear the cost of getting established, there is some argument that they should be permitted to take that risk. As matters stand at present, it would be pretty difficult to establish that more financial institutions are in fact needed in Canada.

A further consideration that may need reform is the question of initial financing. In the federal Trust Companies Act and the Loan Companies Act, there are minimum capital requirements before a charter may be granted. Of course, under the discretionary head, the minister may demand higher amounts of initial capital in the light of

the proposed operating plans, and so the minimum stated in the legislation may not be of much significance. However, it has a role, provided that the initial requirement is high enough. A high requirement for initial capital would mean that only people who are seriously interested in a permanent business development would seek a charter, and the investors, in the light of the amount involved, would have to be strongly convinced that the proposal has a good chance of success. It therefore would seem useful to place a high initial capital requirement in the statute, regardless of operating plans.

This may close the door to small local operations, but the importance of financial soundness and the existence of deposit insurance must override this consideration. Deposit-taking should be permitted only where the financing is strong.

A high initial capitalization also gives time to substitute actual experience in management style and investment decisions for impressions and forecasts, while still leaving enough resources to meet liabilities should the enterprise fail. It is always to be expected that there will be initial costs and net operating losses in the start-up phase, and so there must be enough resources on hand to permit experience to be gained in this period before safety margins are exhausted.

Corporate powers and financial standards

The next broad category mentioned is that of corporate powers and financial standards. Under this head I do not propose to discuss matters of internal corporate government involving bylaws, shareholders meetings, voting rights, etc. These are important matters but are part of general corporate law and do not bear directly on the questions of solvency and consumer protection now under consideration.

There is, however, a special aspect of internal government and management that merits some attention, namely, the responsibility resting on the board of directors. Corporate law generally has tended to increase the responsibility placed on corporate directors, and it may be that directors of financial institutions should have special responsibility. I mention this only in passing, but it is an aspect that merits close attention.

The corporate powers that are relevant for the matter in hand are first, the area of public activity that will be open to the company – that is to say, the kind of liabilities it will be enabled to create – and, second, the powers and restrictions concerning investing and lending of the funds raised from the public.

The question of the kind of activity that will be open to the company raises the issue of the so-called four pillars in the financial system and the whole matter of diversification of activities. So far, although there is blurring at the edges, the general pattern has been to confine each company to one of the four general categories. The purpose of this division is not to restrict entrepreneurship but rather to try to achieve some more-or-less uniform classification of liabilities, so that in considering investing and lending powers and restrictions, some reasonable match can be made between the liabilities on the one hand and the assets on the other. This is important and relevant in considering financial stability, since an asset portfolio must be designed in the light of the nature of the obligations expected to be met by those assets. Matters such as interest guarantees, duration of liability, and contingencies giving rise to payment are important. If diversification is to be considered, therefore, for any one particular ownership or management group, it would be strongly in the interests of financial solidity to hold to a pattern that will result in the combination of more-or-less homogeneous liabilities within any particular corporation, even if several corporations are under common ownership. This is, in fact, regulation by function, which seems nowadays to be attractive to some in discussing regulatory reform. The fact that it shows up as regulation by type of institution is merely a consequence, not a basic thrust. The type of institution follows the activity rather than vice versa.

The issue of diversification and, in particular, of the operation of a number of companies under common ownership raises the problem of investments and loans that are not at arm's length and may therefore give rise to a conflict of interests. It is extremely important that everything reasonably possible be done in the regulatory structure to try to ensure that investing and lending decisions on behalf of a financial institution are made in the exercise of the best judgement of the persons concerned relative to the interest of that institution and no other. No attempt in governing legislation to establish criteria for investment and lending, however elaborate, can substitute for

informed and objective judgement on the part of people having the actual decision-making power and responsibility. If that judgement is clouded by other interests, consciously or unconsciously, a serious danger may be created for the welfare of the financial institution.

It is well recognized that this is an important and relevant subject in considering the regulation and operation of a financial institution. In a number of difficult cases that have arisen in recent years the problems have been created by controlling shareholders causing a financial institution to act in a manner that is not in the best interest of that institution. Views differ on how an adequate measure of protection can be achieved.

Some hold the view that the best course is to eliminate potential conflicts by limiting the degree of ownership and so the influence of any one shareholder. This would remove the possibility of the main type of conflict, although it would not solve the problem completely, since there might still be conflicts of interest on the part of management in a company that is widely held. Also, as a practical matter, it has been noted that even where there are ownership restrictions, as in the banking legislation, it is a practical necessity to make some exceptions to permit new institutions to be formed and get started. We also see further exemptions from such ownership restrictions in the case of Canadian subsidiaries of foreign banks.

Others hold the view that matters of conflict of interests in investing and lending can be adequately controlled through legislative restriction on certain kinds of activity. This in fact is the approach under federal legislation (other than banking law), which, as a general principal, prohibits investing and lending where major shareholders or persons in the decision-making group have or may have a conflict of interest relative to the investment transaction under consideration. These provisions have served a reasonable purpose but should, I believe, be strengthened. If there is to be diversification through further creation of separate companies under common ownership, there should be no compromise with the principle that a financial institution not lend money to or invest money in any company where that company and the financial institution are under the same control. Neither should there be any compromise with the principle that a financial institution should not lend to or invest in a major shareholder.

On the question of investing and lending powers generally, the approach under the banking legislation has been to grant banks the power to engage in banking (without any particular definition of that term) and then to impose certain restrictions on investing and lending. This is generally interpreted to leave banks free to make investments and loans on the basis of their own discretion, subject to certain limitations such as a maximum ratio of loan to property value in the case of mortgage loans, a limitation on ownership of common shares of other companies, and limitations on loans to officers and directors.

For trust companies and loan companies, the tradition has been rather to spell out in the legislation certain classes of eligible investments and loans and to give companies the corporate power to act within those limits. Restrictions have also been imposed along the lines described for the banks, limiting investments in common shares, putting a maximum limit on the ratio of loan to property value in the case of mortgage loans, prohibiting loans to officers and directors, and barring loans where there may be conflict of interests on the part of substantial shareholders, directors, or officers.

Over the years, the investing powers of trust companies and loan companies have been steadily broadened. With the inclusion of a so-called basket provision, permitting a certain proportion of the assets to be invested at the company's discretion, these corporate powers are now very broad indeed – perhaps so broad as to be misleading in the sense of causing people to believe that the asset portfolio created within those powers is of higher quality than in fact may be the case. In particular, the eligibility tests for investing in corporate securities might well be dropped, since such investments have never been of major importance to trust and loan companies.

Regulation should then concentrate on matters that experience has shown to be a source of danger, namely, excessive concentration of loans to or investments in any one borrower or any one issuing institution, excessive single loans, excessive investments in equity-type assets (shares and real estate) where these are held in relation to liabilities that are interest-bearing, inadequately secured mortgage loans, and matters of conflict of interest.

The matter of mortgage lending needs special attention. Lending on real estate mortgages has, of course, been the main investment and lending activity of trust companies and loan companies through the

years. More recently, this type of lending has become less dominant in the portfolios of such companies, partly by reason of competition from the banks in the field of mortgage lending, particularly residential mortgage lending, and partly by reason of a shift in the nature of the liabilities of the companies. With recent high and volatile interest rates, there has been a strong tendency on the part of customers to seek short-term savings instruments. Trust companies and loan companies have therefore been forced to shorten the duration of their assets in order to get an appropriate match, and this has tended to push them in the direction of short- and medium-term corporate loans as distinct from their traditional field of residential mortgages. This, of course, raises an important point concerning the extent to which short- and medium-term corporate lending should be considered exclusively a banking activity and should be restricted to banking-type operations rather than loan- and trust-type operations.

Notwithstanding the shift just mentioned, mortgage lending is still the principal outlet for funds raised by trust companies and loan companies, and regulation to date has merely specified that a mortgage loan may not exceed 75 per cent of the value of the underlying real estate unless the excess is appropriately insured. It has been assumed over the years that 'value' in this sense means market value, and there is indeed authority under the legislation to seek special appraisals should the regulatory authority arrive at the conclusion that the loan is inadequately secured by the underlying real estate. Experience in recent years, particularly in an inflationary environment, has shown that this simple requirement does not achieve as much protection as might be desired. In such an environment, values go up rapidly and mortgage loans based on those values may cease to bear any relationship to the ability of the borrower to repay. In the case of loans on commercial properties, values may be based on construction costs or anticipated rents, and in the case of residential mortgages, values may be based on rapidly rising market prices in a boom environment where the people undertaking the mortgage loan are gambling on future inflation of income to enable then to meet the payments. If the boom collapses, the underlying security or a good portion of it simply vanishes. We see this happening right now.

There is no easy solution to this problem. Some things can, however, be done. First, for commercial mortgages, there should be some limitation on the extent to which a company can lend money on

mortgages where the underlying property is not actually producing a cash flow that will at least service the mortgage. This should be a real cash flow, not projected income on the basis of possible rental receipts or income arising from realization of overdue or deferred interest payments. Second, there should be a limitation on the size of any mortgage loan related not only to the loan itself but to the sum of all mortgage loans on the particular property that rank equally with or superior to the loan in question. Problems have occurred where a company undertakes a second or a third mortgage for a modest amount, seemingly well within its ability to handle, but then finds itself forced either to abandon its claim or to take over the prior-ranking mortgages in order to protect its position in the event of default. While it may be going too far to prohibit second and third mortgages completely for a financial institution, certainly the total mortgage obligation on the property ranking equally with or superior to the mortgage undertaken by the institution in question should be well within a size that is appropriate for that institution.

A further provision is needed concerning the value of property where there is a dispute. The procedure for obtaining appraisals and the difficulty that arises where there are conflicting appraisals, as there well may be since appraisals are matters of subjective judgement on the part of the appraisors, make it extremely difficult for a regulatory authority to do what should be done to protect creditors where there seems to be a strong bias in the direction of over-valuation of property. It may, in fact, be necessary to give almost arbitrary authority to the regulators to adjust the balance sheet where they are not convinced that the values are well supported. Some may protest that this puts too much authority in the hands of the regulator, who may not be an expert in real estate evaluation. Nevertheless, having observed problems created by conflicting views of real estate appraisors, I believe protection of the public demands that someone be able to act promptly in problem cases.

It is worth nothing that up until 1961, mortgage lending powers for trust companies and loan companies (and insurance companies) specified that the ratio of a mortgage loan to the value of the underlying real estate could not exceed 60 per cent. This was increased to 66 2/3 per cent in 1961 and to 75 per cent in 1965. These successive increases were made in a period of economic prosperity when losses on mortgage lending were very low indeed. One of the justifications

for the successive increases was that mortgage lending, particularly on residential property, was almost universally on the basis of a monthly amortization of principal and interest. This was in contrast to the pre-Second World War practice that usually involved interest payments on a regular basis but payment of the full principal on maturity. It was considered that the monthly amortization was a much safer basis, since the amount of the debt was steadily decreasing during the term of the mortgage, thus increasing the ratio of the security to the outstanding debt.

A further reason for the increase was the pressure for funds to permit housing development and the search for means to reduce the required down-payment for purchase of houses. Prior to 1965, when the limit was changed to 75 per cent, a number of unregulated companies were established to make second mortgages to cover the amount of the purchase price between the two-thirds limit that could be provided by the regulated mortgage lenders and the balance remaining after the minimum down payment by the purchaser. The second mortgages were usually at a high rate, and there was thus some attraction to increasing the limit available to the regulated mortgage lenders in order to reduce costs to the borrowers. It is also to be noted that this increase came about the same time that private mortgage insurance was established. In retrospect, it appears that the increases may have been excessive. Certainly, recent experience has shown that a margin of 25 per cent does not in fact provide much safety. Where a mortgage loan goes into default, the cost of foreclosure plus the overdue interest by the time foreclosure is achieved will use up most if not all of this 25 per cent margin. Given recent experience, it may be that the 75 per cent limit should be cut back to a much lower amount unless mortgage insurance is obtained or unless the lender is able to establish a special reserve respecting mortgages over a specified amount.

The other important financial standards that I would like to refer to are the ongoing capital and surplus requirements and the required liquidity reserves. The principal measure used for regulating the growth of trust and loan companies and for maintaining a safety margin for protection of creditors has been control over the leverage, that is the ratio of the liabilities undertaken by the company to its capital and surplus base. Under the Loan Companies Act, a loan company starts with an authorized ratio of debt to capital and surplus

of 4 times, and a trust company starts with a ratio of $12\frac{1}{2}$ times. These ratios can be increased by the adoption of an appropriate bylaw by the company, subject to the approval of the minister of finance.

Over the years, the maximum ratios for trust companies have steadily increased from 5 times in 1914 to 7 times in 1931, to 10 times in 1947, to $12\frac{1}{2}$ times in 1958, to 15 times in 1965, and to 20 times in 1970. For loan companies, the ratio progressed from 4 times in 1914 to 6 times in 1927, 10 times in 1948, to $12\frac{1}{2}$ times in 1958, to 15 times in 1965, and to 20 times in 1974. In 1974, the statutory limit was removed, and companies were able to go beyond 20 times with the approval of the minister of finance but only on condition that they were able to comply with certain financial standards spelled out in the regulations.

The general pattern has been for companies to move up gradually from the starting ratio to 20 times, usually in stages over a period of years and then to progress beyond 20 times if they can comply with the Financial Standards Regulations and otherwise justify the additional growth. It is to be noted that if a company is operating at a 20-times ratio, the margin of assets over liabilities is something under 5 per cent. The maximum ratio that has been approved for companies at the federal level has been 25 times and this means a safety margin of something slightly under 4 per cent.

Recent liquidations make it clear that a margin of 4 per cent or 5 per cent is quite inadequate to cover the losses that are thrown up as a company moves from a going concern to liquidation. It is doubtful that even a margin of 10 per cent would be enough to ensure that a company could meet all its liabilities if it were closed at the point when its published balance sheet showed the company up to its borrowing limit. This almost forces one to the conclusion that if a company runs into trouble, the kind of margin available if the company is operating at any ratio that exceeds 3 or 4 times is unlikely to be enough. The kind of safety margin achieved by these borrowing ratio limits is therefore not of much significance in a liquidation. The conclusion is that these ratios are of more use to limit the growth rate of the company than to ensure a safety margin. This is not to say that limiting the growth rate is not an important factor: such limitation operates in a very salutary manner, since companies can be required to show good management and a profitable operation before any increase in the borrowing ratio is permitted. Companies, of course,

are nearly always pressing for higher ratios in order to increase the profit potential on any given capital base.

It seems that from the point of view of solvency, there has tended to be more reliance on the borrowing ratios than is justified. It seems essential therefore to search for some other criterion that will come into play at a much earlier point than a borrowing ratio test and thus will give an earlier warning of impending troubles. If such a signal can be devised and if authority were to exist to terminate a company's operations or force substantial additional capitalization at that point, heavy losses on liquidation might be avoided.

The most promising early warning signal of this type seems to be a measure of the interest rate spread between the interest paid on liabilities and the interest earned on assets, and the trend in this spread. If such a test is to be useful, it would have to be applied on the basis of a strict cash flow comparison. On the income side, one would have to take into account only investment income actually received, thus setting aside any capitalization of overdue interest and ignoring revenue produced by fees of various sorts unless they could be clearly identified as being part of the income on loans and investments.

The Financial Standards Regulations, referred to earlier, were an attempt to design criteria that could be used to measure the needs of a particular company for capital and surplus. They attempted to measure the quality of a company's asset portfolio, its cash flow position in the sense of comparing known cash needs with expected cash income over a period of time, its liquidity exposure in terms of its ability to meet unexpected withdrawal demands, and its profit record. These are all relevant for measuring the ability of a company to withstand adverse circumstances, but, as previously mentioned, if they are applied at the point where a company has already reduced its capital and surplus margin to under 4 per cent, it is usually too late to avoid losses if a company gets into a position where it cannot recover.

The tests applied under the Financial Standards Regulations are carried out in relation to each company, and it might be helpful if the results of such tests were to be published. Even if they did not have much effect on the consumer, they would exercise a considerable discipline on the companies themselves, since they would quickly be picked up by competitors and knowledgeable financial advisers.

For banks, there was no statutory requirement relative to capital and surplus until the most recent amendment to the Bank Act. Under

that statute, a provision was inserted requiring banks to maintain adequate levels of capital and to comply with regulations or ministerial directions in that matter. No regulations have yet been adopted, but the Inspector General of Banks has issued guidelines and has, of course, monitored the capital and surplus levels for banks both before and after the statutory amendments referred to. For banks, however, the borrowing ratio was never as rigidly controlled as was the case for the loan and trust companies.

So far as liquidity is concerned, the Trust Companies Act and the Loan Companies Act have statutory liquidity requirements to the effect that each company must maintain reserves in the form of deposits with approved depositories, government securities, and bank acceptances equal to 20 per cent of its demand liabilities. This test has not proved to be a rigorous one over the years, and most companies maintain liquid reserves beyond the statutory requirement. However, there is continued pressure for expanding the classes of assets that can be taken into account for liquidity purposes. Generally, the liquidity needs of each company depend very much on the nature of its liabilities, and it is likely that improved liquidity strength could be achieved by requiring each company to put forward a plan in the light of its own operations and by making this plan subject to approval or amendment by the regulatory authority.

Under the Bank Act, there are no specific liquidity reserves, but the statute does require each bank to maintain adequate levels of liquidity, and, of course, reserves must be maintained in the Bank of Canada.

The liquidity measure used under the Financial Standards Regulations is much broader than the statutory requirement for loan and trust companies and might, in fact, be usefully applied to all companies rather than only to those that seek to expand beyond a 20-times borrowing ratio.

A further approach to the liquidity question would be to compare short-term assets and short-term liabilities. If the difference exceeds a certain proportion of the company's assets, some additional reserve should be required. A company's exposure to swings in interest rates is very much measured by the extent to which its short-term assets exceed or fall short of its short-term liabilities.

To summarize, it seems that the financial standards traditionally imposed could be improved by dropping the detailed description of

eligibility for corporate securities and putting more emphasis on certain investment restrictions such as limiting equity-type investments, the size of individual loans, and exposure to any one borrower or security issuer, and strengthening the rules related to conflict of interest. Further, initial capital requirements might be increased.

For mortgage lending, there should be limits on mortgages other than first mortgages to ensure that companies do not become unduly exposed by having to take over higher-ranking mortgages in the event of default. There should be more authority in the hands of regulators to make rulings in the case of disputes about property values, and consideration should be given to reducing the ratio of mortgage loan to underlying value unless mortgage insurance or special reserves are in place.

Control of growth and capital and surplus margins through the use of approved borrowing ratios should be supplemented by careful attention to levels and trends of interest-rate spread between assets and liabilities where the investment yield on assets is measured on a strictly cash basis. There should be strict limits on commercial mortgage lending where the underlying property is not producing enough income to service the mortgage.

The kinds of tests arising under the Financial Standards Regulations or some adaptation of them supplemented by tests relating to the volume of overdue interest and perhaps some other relevant measures should be performed by each company and filed with the regulatory authority. Further consideration should be given to publishing the results of such tests.

Disclosure

The third area of governmental requirements bearing on solvency of companies relates to information flow. This is important in regard to information flowing to the regulators, to the directors, to the shareholders, and to the public. Information flowing to the regulators is obtained through the required filing of a detailed annual financial statement and through the filing of periodic statements, some showing only assets and liabilities and some showing only the changes in investments and loans. Further, regulators are empowered to call for additional statements as they see fit. In addition to the statements and information so filed, the regulatory legislation requires the

supervisory authority to make an annual inspection of each company at its head office.

Generally speaking, the flow of information thereby achieved is adequate for the purposes of regulation. Companies are not so numerous that it is at all difficult to identify and keep track of companies that are encountering some financial difficulties. The establishment of early warning systems as suggested by some may be a useful supplement, but it is doubtful that any system that can be devised will produce much earlier information or information in addition to that obtained under existing rules and regulations. The problem here is not really so much that of information flowing to the regulators as it is to decide at what point regulatory discipline should be applied either to force a change in operating pattern or to cause a company to discontinue borrowing from the public.

Information flowing to the directors is not dealt with in any particular detail in the regulatory legislation. Financial statements required to be filed and published are usually placed before the board, and the statements that have to be filed must be signed by at least one director. It might be beneficial if there were more statutory requirements forcing a flow of certain information to the board. Some experience has shown in the past that the board of directors is not always as well informed as it should be, particularly where companies get into trouble. Requests or directions from regulators sometimes are stopped at the management level and do not reach the board. This could of course be corrected by requiring that any correspondence between the regulators and the company be sent not only to the management but also to each director. This is sometimes done in particularly difficult cases, but under present practice it is regarded as being very severe action rather than a normal flow of information to the board.

Most of the legislation requires certain minimum information to be placed before the shareholders at the annual meeting, but the existing legislation is not specific in this matter, at least so far as trust companies are concerned. The banking legislation is much more detailed concerning the information to be filed with the regulators and to be published periodically, as well as information to be placed before the shareholders.

So far as information to the general public is concerned, present rules rely on the regulatory authority publishing this information

either in the Canada Gazette, as in the case of the banks, or in the annual report of the Superintendent of Insurance in the case of the trust companies and loan companies. It seems doubtful that publication of information in this way does very much so far as market discipline is concerned, at least from the point of view of the man in the street. Nevertheless, it is desirable to continue this kind of publication. It would also be valuable to make the financial statements as deposited with the regulatory authority available for public examination. This is now done in the case of banks. In the case of federal trust companies and loan companies, there is no right under the statute for the public to examine the statements, although they are published in the Superintendent's Report and are made available in a publicly accessible computer data bank. The main defect concerning the publication of the statements in the Superintendent's Report is that the time taken to prepare the statements and to get the publication out is such as to diminish the value of the data by the time it becomes available to the public.

Generally speaking, it seems that the information flow now required is adequate but could be supplemented by further specific tests, perhaps by publishing the test results and by giving the public access to the statements as filed with the regulatory authority.

Disciplinary powers

The fourth area of importance in connection with protection of the public relates to the disciplinary measures available to the regulatory authority where companies fail to comply with the statutory requirements and regulatory directives, or are otherwise facing serious financial difficulty. At the present time, the statutes relative to trust companies and loan companies have a fairly elaborate procedure, starting with the requirement that the superintendent must report to the minister in any case where a company is in violation of its authorized borrowing ratio or where he considers that the company's ability to meet its obligations is inadequately secured. The minister, after considering the superintendent's report, and giving the company a chance to be heard, then may take one or more of three courses of action. He may give the company a period of time to remedy the defect or improve its financial position; he may impose specific conditions in the company's licence; or he may instruct the superintendent to take control of the company's assets. If matters are not rectified, he may

then apply for a court order to liquidate the company or to have the superintendent take control of the company for its management and rehabilitation.

The procedure so set out seems to be adequate, but much depends on the point at which the superintendent reports to the minister and on the period of time given to the company to remedy the situation. As matters stand, it appears that some means are needed to advance the whole procedure so that it may cut into a company's operations at an earlier point than present rules require. However, this is easier said than done. It remains a matter of judgement to decide at what point a company's position is approaching the danger point and how rigorous the requirements should be as a consequence. It seems that losses to creditors will be avoided only if a company's activity is terminated at a much earlier date than has been done in the past. This might mean that some companies are required to terminate at a point where it is conceivable that they might be able to recover their financial strength. However, if a choice has to be made, it seems that it must be made in favour of the creditors rather than in favour of the shareholders and owners. If the criteria are clear and objective, company management and owners would know the rules and would have to govern themselves accordingly. However, it is impossible to avoid a subjective judgement in considering the issue of insolvency.

In terms of protection of the depositor, the concept of insolvency has to be that an institution is to be deemed insolvent when the probability of its being unable to meet its obligations in full becomes unduly high. I use the term 'probability' not with the idea of mathematical precision but rather to emphasize that we are dealing with a dynamic situation involving many factors rather than a situation responding to such tests as those used in ordinary definitions of insolvency. Since judgement is involved, the next question is 'Whose judgement?' There are three possibilities: the company itself through its shareholders and directors, the regulators, and the deposit insurance administration.

It is clear that action to declare insolvency would be taken by a company itself only if the chance of continuing to meet all its obligations were very small indeed. This might be considered as one extreme. Such action by a company is not to be questioned, since once the company has lost the will to live, rehabilitation would be impossible. At the other extreme is the deposit insurance admin-

istration. If it were to act with only its insurance risk in mind, it would want to declare an institution insolvent at a very early date in order to wind it up while there were still some margins available, in the hope of avoiding or minimizing the insurance claim. Between these extremes is the regulator. He should be able to take a balanced view, conscious, on the one hand, of the desire of the company's shareholders and management to protect their investment and have the chance to recover from a problem position, and, on the other hand, of the increased risk to the deposit insurance plan if a troubled institution is allowed to carry on and take on more liabilities.

All three must, in forming a judgement, consider such matters as the interest spread on current assets compared with interest costs of current liabilities, the realizable value of non-yielding assets, the interest spreads obtainable on new business, the trends in problem loans, the remaining capital and surplus margin, the chance of more capital being raised, the skill of management, and the competitive environment.

The regulator has various tools available. He can put a ceiling on liabilities, thus stopping further growth and, to that extent, fixing the deposit insurance exposure; he can put a ceiling on interest rates offered, thus also controlling growth and increasing interest margins on new business; he can require more capital; he can force the write-down of assets of doubtful quality; and he can also attempt to reduce the risk of inadequacy of assets by requiring a reduction in liabilities.

All these actions would be moves in the context of a situation that has some hope of recovery. But it is difficult to determine how much hope and who should bear the risk if things do not work out. Some companies will say: Do not put a ceiling on growth, but instead give us more leverage so that we can take in more business, make money, and so recover from this temporary difficulty. But business profit is never a certainty, and the regulator cannot accept such an argument, since it would, in effect, put the deposit insurance plan in the position of providing the safety margin for new insured depositors and would leave new uninsured depositors in a position of taking a kind of shareholders' risk without the benefit of any profit should the enterprise succeed.

Action to shut off new business would be tantamount to liquidation, since no company could hope to do a simple run-off from its own resources except in very unusual circumstances. A requirement to

reduce liabilities and so restore a better margin of capital and surplus compared to liabilities might seem attractive, but the result could be damaging: the better assets would have to be liquidated to pay out maturing liabilities, and the remaining portfolio would deteriorate in quality.

So the task of the regulator is difficult, and since human judgement is rarely perfect, there may be some cases where a company is closed too soon, giving rise to complaints and even lawsuits from shareholders, and others where action is perceived by some to be too late, thus giving rise to complaints and criticism from those who finance the deposit insurance plan and from others who expect all action to be perfect.

Under banking legislation, the question of insolvency is equally vague. The Bank Act states that a bank is deemed to be insolvent if it suspends payment of any of its liabilities in notes of the Bank of Canada for 90 days or more. In such an event, its powers are limited to those necessary to wind up its affairs. If a bank suspends payment of any liabilities as they fall due, the minister of finance may appoint a curator to manage the bank's affairs. The minister may also appoint a curator if, at any time, the Inspector General of Banks reports that in his opinion the bank will not be able to pay its liabilities as they accrue.

Where a curator is appointed after a report by the Inspector General of Banks, the bank is not thereby specifically deemed to be insolvent. An application for a winding-up order would have to be based on proof to the court that the bank is insolvent, and, as in the case of a loan company or trust company, the assets and earning power would have to have deteriorated pretty far to produce such proof – probably well past the point of avoiding a substantial loss on a liquidation. There is an additional complication in the case of a bank, since under the Winding-up Act a winding-up order cannot be issued until a meeting of shareholders and creditors is convened for the purpose of, to quote the Act, 'ascertaining their respective wishes as to the appointment of a liquidator.'

So the determination of insolvency and the winding up of a bank are even more formidable than they are for a trust or loan company. In terms of action early enough to limit losses, it depends again on opinion concerning asset values and earning power, since maturing liabilities can be met for a long time after a bank clearly has

insufficient assets to pay all its outstanding liabilities. The plain fact is that there is no escape from the need to exercise judgement, and it seems clear that the main responsibility must lie on the regulator, which, of course, includes the responsible ministerial authority.

It may be that the deposit insurance administration should have some voice if it perceives that it is becoming unduly exposed, but any power that may exist to cancel insurance coverage must be used with great caution, because, unless it were used in conjunction with a freeze on assets and an application for a winding-up order, the result would almost certainly be a run on the company with likely insolvency at some point. In the mean time, some depositors would get out whole and others would not. In the end, the ultimate authority must lie with those who are politically responsible and must answer in the legislature. There is no automatic formula and no case to rely exclusively on one extreme – the company – or the other – the deposit insurance administration.

The approach described leaves the deposit insurance plan exposed to risks that it cannot control while the regulator tries through some of the means cited to direct the operation of a company toward recovery of strength. I think that this is a situation that must be accepted if a balanced approach to imposing financial discipline is to be achieved through an effective regulatory system. I repeat that deposit insurance itself is valid only in the context of a regulatory system that can and does reduce the chance of failure of financial institutions to a low level with a low expectation of loss where there is a failure.

There is, of course, a potential problem of some difficulty in a divided jurisdiction. It seems reasonable in looking at the federal jurisdiction in Canada to expect a degree of co-ordination between the regulatory authority and the deposit insurance administration that would make the above-described situation tolerable. The government itself could always take action to resolve conflicts within its own jurisdiction. But where a federal plan insures a provincial company, the resolution of conflicts is not as easy. It is possible, of course, for the deposit insurance plan to impose conditions before accepting a provincial company, but the ongoing position is the difficulty. As mentioned above, termination of insurance is a doubtful tool, and yet unless there is full co-operation from the provincial regulatory authority, there is no other way to enforce standards.

A partial solution to this problem would be to empower the deposit insurance administration to levy penalty premiums on member institutions that, while operating within the applicable regulatory requirement, were perceived by the deposit insurance administration to be straying from sound practice. If such premiums were large enough, they would be effective in influencing management style and in controlling some dangerous trends.

It does not seem that any difficulties arising from time to time in relation to regulatory standards for provincial companies, including the insolvency decision, should be taken as serious enough to abandon the effort to have a single plan of deposit insurance that is ready to cover all deposit-taking institutions. To do so would no doubt give rise to a plan in each province with many consequent problems and uncertainties. Generally, it seems to me that there has been provincial co-operation and a responsible attitude on the part of provincial authorities. Neither would I move to give dominant regulating power to the deposit insurance administration, since, as already mentioned, it should be a minor though important element in the regulatory system.

DEPOSIT INSURANCE

Having surveyed the regulatory network, I now turn to look at deposit insurance and how it might operate as the general safety net to provide protection when other means have failed.

Should there be a guarantee plan?

It is generally accepted, I think, that no system of financial standards and supervision can hope to be 100 per cent effective in protecting every creditor of every financial institution from loss under every circumstance. It may be that if a system were sufficiently severe it could reduce probability of failure to almost zero, but the result would be a regulatory system that would interfere with normal business development, with the ability of financial institutions to change and react to customer needs, and with the development of competition; further, it would result in costs to the customer in lower returns on savings and investments.

The establishment of a system of supervision and regulation by a governmental authority has never been regarded as carrying with it a

guarantee by the government concerned to provide protection or pay damages should the supervisory system be less than perfect. This applies not only to the regulation and supervision of financial institutions but in other aspects of consumer protection such as securities commissions, food and drug standards, and weights and measures standards.

It is true that governments have sometimes stepped in to provide financing or guarantees for business enterprises that have faced the immediate prospect of failure, but only on a case-by-case basis and presumably as a result of the judgement by government and the legislature concerned that the move was in the public interest. Whether one agrees with particular decisions or not, the principle is still one of a case-by-case consideration rather than a general guarantee in the light of having established a supervisory system.

I do not think that anyone would propose now that there be an absolute government guarantee of solvency for all financial institutions. Some people may have formed the view that, in the light of recent governmental action relative to banks, there is an implicit guarantee to that effect for banks covered by the Bank Act, but I think that one swallow or even two swallows do not make a summer. It would be dangerous, I believe, to assume that there is in place any governmental commitment to guarantee solvency of every bank in all circumstances. If we reject that assumption, even though there is an established system of supervision and regulation, and accept that it is not appropriate to establish such a guarantee, do we want a partial guarantee for companies that fail despite the regulatory system, and, if so, how much and how financed?

Quite clearly, there should be a plan. Experience here has shown its value. No one now is proposing to scrap it. In other countries, guarantee plans have been adopted for financial and insurance institutions. Even where other financial institutions are ready to contribute on a voluntary basis to save customers of a failed institution from loss, they usually find it impossible to organize matters in a timely and fair manner to do what has to be done. An established insurance or guarantee plan provides the organized structure to achieve a fair distribution of costs and a prompt response to problems.

When deposit insurance was considered in Canada in the 1960s, prior to adoption of the existing plan in 1967, the atmosphere was one

of considering the whole question of legislation relative to financial institutions, and to banks in particular, in the aftermath of the 1964 Report of the Royal Commission on Banking and Finance (the Porter Commission). That commission had studied banking in Canada, including deposit-taking by non-bank institutions, and had recommended that the federal government seize jurisdiction over banking activities, which they defined as the acceptance of deposits repayable on demand or within a year. The Porter Commission had the idea that it would be possible, with adequate supervision, to reduce the probability of failure to a low level and that guarantees in the form of deposit insurance were not necessary.

As is now known, the recommended course was not adopted by the government of the day, and, instead, consideration was given to means of improving and making more uniform standards applicable to deposit-taking institutions, to providing a system of emergency liquidity for companies that were taking deposits but did not have access to the Bank of Canada as did the banks, and to providing guarantees against loss to depositors. The essential philosophy was one of improving financial standards and reducing the risk of loss to the point where the implementation of the actual guarantee would be rare and would arise only in the event of highly unusual circumstances.

Although it may seem ironic in light of the events of the last two or three years, the thought was originally that the claims would be very few in number and that, where they occurred, the losses would not be large. The main cost of the deposit insurance plan was thought likely to arise from the need to finance the pay-out of deposits when a liquidation occurred; it was not thought that the actual loss would be large in any case, since the regulatory procedures were considered to be adequate to close up an institution before the financial position deteriorated to the point of resulting in a large shortfall of assets to meet liabilities.

As I noted, recent events have changed the perspective a little but should not, I think, distort the whole view. The objective of regulation should still be to reduce failures and consequent losses to a low level.

Amount of insurance

The general pattern in other countries in establishing guarantee plans among financial institutions has been to use a system of partial

guarantees financed by either pre-assessment or post-assessment levies on the participants in the industry concerned. In the United States, such partial guarantees are in place in most states relative to insurance companies (both life and property and casualty), and, of course, there is a deposit insurance for banks and another for savings and loan companies. The partial guarantees are defined in terms of maximum limits on insurance claims settlements and on insured deposits. In the United Kingdom, similar provisions are in place, but there the partial guarantees are achieved by means of a type of co-insurance arrangement, since the guarantee plans do not provide 100 per cent protection for any level of liabilities.

The limit chosen in 1967 for the Canadian plan was $20,000. This amount was thought large enough to cover deposits in normal savings accounts, where it would hardly be worthwhile for the depositor to make a detailed study of the financial strength of the company or bank with which he or she proposed to deal. The US plan was also a major influence. The limit now stands at $60,000, having been raised from $20,000 in 1983. The only apparent reasoning in fixing this amount was that of applying the increase in the consumer price index to the original limit. The new figure goes well beyond normal savings account balances and is clearly insuring investment instruments. Once this philosophy is adopted, it is hard to know where to stop. Already, one hears proposals to go even higher.

Pressure for the increase arose partly because of growing affluence and partly because of inflation, since both tended to result in higher incomes and larger deposit accounts and savings instruments. Also, development and growth of RRSPs began to stimulate interest in coverage for amounts much larger than $20,000. It was also recognized that insurance well over $20,000 was being obtained through the use of joint accounts and creation of parent and subsidiary insured institutions. The existence of deposit insurance even at the $20,000 level no doubt had an effect on savings habits and attracted much more money to the institutions offering insured instruments than would have been the case without this insurance. It seems that the existence of a guarantee plan tends to increase levels of insured savings at the expense of other forms of investment, thus generating pressure for higher and higher insurance limits.

The main problem is one of maintaining management discipline, whether imposed by management itself, by the market, or by the

regulators. If there is an unlimited guarantee, then weak or poorly run companies gain an advantage on others, and losses may mount if unscrupulous operators are allowed to exploit the plan by offering high rates for deposits. A limit on coverage checks this to some extent, but the higher the limit, the less incentive for the depositor to exercise judgement. I will come back to this point later.

Definition of deposit

The question of what kind of deposit to insure posed a number of problems. At first it was thought that the insurance should run only to savings-type deposits withdrawable on demand. However, the trust and loan companies had a large volume of money on term deposit, particularly five-year term, and the banks were also beginning to issue term deposit certificates in moderate amounts. The final decision was to insure not only demand deposits but also term instruments up to a term of five years. This limit was chosen in order to avoid interfering with what might be regarded as the normal investment market. It was thought that any extension of a guarantee to investment instruments beyond this term would provide an unfair advantage in the market to funds collected through insured institutions.

This definition has served well enough. Confusion sometimes arises over longer-term deposits, but there seems to be no pressure to change the basic definition. Foreign currency deposits are not insured. Generally, it was thought that the insurance, since it is financed by companies and banks active in the Canadian market, should be confined to Canadian depositors. Foreign currency deposits would usually be made by non-residents and in any case would carry an extra risk because of exchange fluctuation.

Financing

The other important decision at the outset was that the plan should be financed by an annual levy on the insured institutions through the device of a premium. The premium level struck, 1/30th of 1 per cent of insured deposits, was more or less arbitrary in the context and somewhat lower than the premium then being used in the US plan. It was thought that the deposit-taking industry in Canada was more compact than that in the United States, and the financial standards

and regulatory system had generally proved to be more effective in the sense that failures had been very rare indeed. It was generally considered that the very large institutions, both in banking and in trust and loan, were sufficiently well established and sound as to make deposit insurance not essential. However, it was thought that all institutions should be covered and that the premium level then struck was very small in relation to interest costs on deposits and would not represent a burden. It was also considered that it would be possible to build up a modest fund and later to cut back on the premiums to the point where the fund would be maintained by its own interest earnings and additional premiums would be levied only on new institutions and on increases in the volume of insured deposits.

There was to be no government sudsidy except through the establishment of an initial capital of $10 million and the right to borrow from the federal Treasury. The borrowing right, however, did not represent any subsidy, except to the extent that interest rates charged were more favourable than might have been obtained by borrowing directly in the market. Incidentally, the initial capital was repaid in 1977.

Based on the general principle that not more than five years of premiums need be paid on any deposit, reductions in the basic annual premium were in fact made, and, further, some rebates were paid from the accumulated fund. In recognition of the uncertain impact of claims, should failures occur, the original plan provided for borrowing authority from the federal Treasury. Thus, the financing base was one of pre-assessment but with the capacity to switch to post-assessment should claims outrun the accumulated fund. The borrowing authority was further increased in 1983 when the insurance limit was raised to $60,000.

After the events of 1983 and recent years, whereby the claims liability has exceeded the assets of the plan, the financing has moved to a kind of post-assessment pattern. This will no doubt continue, with an increased assessment until the current deficit is removed.

Financial standards

When the plan was started, the question of payment of claims under the insurance element of the scheme was thought to be a minor part of the plan. The main emphasis was on what might be regarded as loss prevention through the establishment of adequate financial standards

and through the power under the plan to provide emergency liquidity and to exercise other preventative measures through the ability to make loans to member institutions and to acquire assets from them. The influence on financial standards, it was thought, could be exercised directly in the federal field by having the board of directors include those government officials most directly concerned with the formation, operation, and supervision of financial institutions. In the provincial field, it was thought that by making deposit insurance available through the federal scheme to provincial institutions, it would be possible to establish adequate financial standards through imposing conditions on the acceptance of a provincial company for deposit insurance and obtaining the active co-operation of provincial authorities in improving regulatory legislation.

Experience has now shown, of course, that the question of the actual insurance and payment of claims has moved, at least temporarily, to a much greater degree of prominence and importance than was originally considered possible. But I believe that a good deal of progress has been made in improving financial standards over the years that the plan has been in force, although, in retrospect, perhaps more could have been and should have been done.

Some improvements in financial standards were made in provincial legislation, but the whole atmosphere was one of easing standards rather than stiffening them, as noted in my earlier remarks. Generally, there was co-operation from the provinces in the establishment and operation of the plan; financial standards were improved, but possibly not fast enough. Nevertheless, I think it is fair to say that the plan of deposit insurance has to date generally achieved its objectives under this head.

Claim payments

In the payment of claims, the plan provides an option – to make transferred deposits available in another institution or to pay off all insured deposits and in either case to acquire the claim of the depositor against the failed institution, to the extent of the transfer or payment. Both systems have been used. That of transferred deposits would be useful only if the interest rate on the deposits was low relative to current rates, and perhaps if a commission payment could be obtained from the transferee institution.

A further course of action is provided through the authority under the plan to make loans to or acquire assets from a member institution to avert or reduce a threatened loss. This power can be and has been used to make loans where an institution is facing a liquidity crisis, thereby enabling the institution to avoid a forced sale of assets with possible heavy loss. The system of loans was also used to permit the liabilities of some closed institutions to be run off as they came due, where this seemed to represent a way of reducing a threatened loss. I believe this flexibility is important to give the opportunity to find the best settlement plan.

There has been criticism of the method adopted in dealing with certain claims, where the Canada Deposit Insurance Corporation decided that it was in its own interests, in the sense of reducing costs, to advance funds to institutions that had been closed for new business in order to enable them to follow an orderly pattern of liquidation of assets while meeting liabilities as they became due. In the circumstances, this course required payment of all deposits, insured or uninsured, to be sure that all were treated fairly. The corporation adopted this course in certain cases where it formed the view that this would represent a lesser cost to it than the alternative of liquidation. In making this decision, it had to take many factors into account. These included the nature of the assets of the company concerned, the ability to realize them, the profile of the deposit liabilities, the problems of getting a liquidation order, the estimated costs of liquidation, the costs of administering the assets and liabilities on a run-off basis, the financial resources available to the corporation, and the financing costs of an immediate pay-out of all insured deposits.

Some people have argued that it was incorrect for the corporation to adopt any plan that resulted in the payment of deposits in full beyond the insured limit when an institution had to be closed. However, it is quite clear that the corporation has the authority to lend to member institutions and to acquire assets from member institutions when this course would result in the avoidance of or reduction of a threatened loss. Acting under this authority, the corporation was clearly within its mandate in making the choice it did.

Others may argue that the insurance element of the scheme should come into play only when an actual liquidation has taken place. This view seems to regard deposit insurance as standing almost apart from the entire regulatory system, as if it were an independent insurance

enterprise. I do not think that this is a tenable position in the Canadian scheme, particularly where the plan is compulsory.

A further view would hold that no insurance should be payable until the losses to depositors have actually emerged and been quantified. This would mean that, where liquidation occurs, no payment to depositors would be made until the liquidation was completely finished. This would mean a delay of a year or perhaps more before depositors, even insured depositors, could get any money at all. Of course, a liquidator might find it possible to pay interim dividends, but, even so, the liquidation would extend over a long period. If the liquidation were slow and the assets of reasonable quality, the interest earned in the hands of the liquidator might be more than enough to cover the asset shortfall at the date of liquidation, eventually paying all depositors in full and giving rise to no insurance claims at all. Such a circumstance, however, would force depositors to bear the cost of losing interest on their deposits for the period taken by the liquidation. I do not think that such a plan would be acceptable to the public, and it would greatly reduce the value of a plan of deposit insurance.

It has generally been thought that if deposit insurance is to be effective for protection of consumers, it has to pay at the point where the financial institution concerned cannot pay in full. This forces the plan to pay out insured deposits at the date of liquidation and to absorb the financing costs while the liquidation proceeds. This issue of financing costs is an important consideration in comparing the liquidation approach with the run-off approach. Under the latter, depending on the profile of maturing deposits and the ability to liquidate the assets of the company concerned, financing costs (interest costs on money that has to be advanced by the insurance plan) may be very much less than in the case of liquidation, where the entire volume of insured deposits has to be paid in full.

Revisions in the plan and its operation

My own view is that the basic structure of the current plan is sound and not very much has to be done. I think a good deal should be done by way of reviewing the financial standards, system of supervision, and disciplinary tools available to regulators, as discussed in earlier paragraphs. I think the objective should be to reduce the losses to a very low level and, when the cost of recent financial difficulties has

been amortized, to reduce the premium charged under deposit insurance to a low level that could not be regarded seriously as being a burden on the financial institutions affected.

It seems to me that the systems adopted for settling claims have been effective and efficient. However, there have been misunderstanding and misinterpretation of the policies followed by the corporation in certain cases in using the run-off approach rather than liquidation. Accordingly, only liquidation should be contemplated in the future in the case of companies that have been forced to terminate operations. This still leaves an important role respecting loans to any member institution facing a liquidity problem or perhaps even the acquisition of assets from it in cases where it is reasonably certain that this action will enable the institution to survive and thus avoid giving rise to a claim.

Some have suggested that where a company is closed, it is important that some depositors lose money in order to create what is referred to as 'market discipline.' I think this is essentially a mistake. The degree of market discipline so created would, in my opinion, be zero for the great bulk of depositors. They are not in a position to get the kind of detailed information that anyone would need to examine the financial position of a particular depository, and even where they could get it, it may take some expertise to interpret it. No one really can be expected to have the time or the ability to act in this way for normal savings deposits. Perhaps deposit brokers or major depositors can afford to make this kind of examination, but market discipline exercised at that level would not have much effect. There is plenty of room within the $60,000 limit to raise money from the public, and as long as insurance exists, members of the public are not going to concern themselves with a study of the financial position of the company or bank concerned.

The $60,000 figure seems rather high for the concept of deposit insurance. Many deposit-taking institutions have subsidiaries, and a depositor can double his or her insurance coverage within one office by putting part of the deposit in the parent and part in the subsidiary and can have separate insurance for deposits in his or her own name and for deposits that he or she has jointly. It is now easily possible for a person to have insured deposits of $100,000 or $200,000 or even more. This, it seems to me, has extended the system of guarantees beyond what was originally intended and perhaps to the point of distorting

the financial market. I suggest that consideration be given to making the insurance limit absolute by providing only that much insurance to any one individual, whether deposits are in one name or in joint names, within one or more member institutions within an ownership group.

Since it seems unlikely that market discipline will have much effect under the current level of insurance, the regulatory system must impose the discipline on the fringe operators to prevent exploitation of the insurance plan. Again, this brings us back to the importance of the regulatory system in creating an environment for the operation of a guarantee plan. Some have proposed a major effort to invoke a real measure of market discipline by cutting back on the level of full guarantee and providing a further layer of guarantee on a partial basis, thus invoking an element of co-insurance on the part of the depositor. I doubt that a plan of this type would accomplish much unless the co-insurance idea cut in at a very low level – lower than the $20,000 originally provided. I also doubt that it would now be politically practicable to cut back very far. If this were attempted, I think that the pressure on governments to compensate depositors for their 'co-insurance' losses would be intense. Although, as I mentioned earlier, the existence of a regulatory system has not in the past been considered as incurring a liability if failures occur in spite of regulation, I am not at all sure that the position would remain tenable where small depositors lose, particularly if protection once offered is removed.

A further proposal in the interests of market discipline is that of a premium structure that allows for some variation in premiums between one institution and another, or between groups of institutions. In the Canadian scene, I do not think that risk-related premiums can be used as a financing base. The great proportion of the financing of any guarantee plan must come from the large institutions, and they are likely to be the strongest. Thus, even if very large premiums were to be set for the weaker institutions, the impact on the general level of premiums would be minimal.

There may, however, be a role for some variation in premiums as a kind of penalty to encourage a shift in management practice. There is always a range of management style within the limits set by regulatory standards. If a system of penalty premiums can be devised, based on objective tests, it might encourage management decisions to

be directed towards the safe end of the allowable range rather than toward the opposite end. In any such system, the penalties would have to be carefully co-ordinated with regulatory standards. They should never become merely a licence to operate risky enterprise.

It is important, of course, for the depositor to know clearly whether or not his or her deposit is insured. It is for this reason that the deposit insurance legislation was amended recently to require member institutions to mark clearly deposit instruments that represent other than insured deposits. This legislation has not yet been proclaimed because of disputes over wording and policy in the so-called stamping provision. The importance of having clarity in this regard has been emphasized by experience in connection with recent failures, where misunderstanding has arisen regarding foreign currency deposits, deposits for periods of more than five years, and deposits that are jointly held.

I think some member institutions are subject to serious criticism for either deliberately misleading their customers or through the lack of management action to instruct employees at the counter concerning what is insured and what is not insured. Clearly, a much expanded degree of supervision of this aspect is going to be required on the part of the deposit insurance administration to avoid such misunderstandings in the future. Whether this should extend to a major revision of the approach to joint deposits, trusteed deposits, deposits in the form of income-averaging annuities, and registered retirement savings plans needs careful study.

A major current problem related to deposit insurance is, of course, the deficit that is now appearing on the balance sheet of the Canada Deposit Insurance Corporation. This is serious but I think not alarming. The corporation still has financial resources available to it to meet claims that are likely to arise. However, some policy has to be adopted soon for eliminating the deficit, and this will inevitably require a much higher level of premiums. It seems to me that the reasonable approach is to strike a new premium rate designed to eliminate the deficit over a period of years and, when that has been achieved, to give attention to setting a level of premiums on an ongoing basis in the light of revisions to the regulatory system as a whole. It is to be hoped that at that time the premium rate can revert to more or less the level contemplated in the original plan. In the mean time, the kind of premium needed to liquidate the existing

deficit, while significantly higher than the premium now being paid, need not be at a level that represents a serious burden in comparison with the interest rates paid on deposits. Even if the premiums required are raised significantly, I think depositors would be quite willing to pay a significant proportion of their interest earnings in order to obtain insurance. I doubt if there is a depositor in the country who would not be willing to pay as much as $\frac{1}{4}$ of 1 per cent of his or her deposits to have the deposit insurance as compared with a higher rate without insurance. Thus, even if a higher premium rate charged to financial institutions results in a decrease in the interest paid to depositors, I cannot believe that this would represent any particular crisis for either institutions or depositors.

I may say in closing that I think the plan has responded in an excellent fashion to the extraordinary crises that have hit it in the past two or three years. I can say this with some degree of objectivity, since although I was a member of the board of directors for the first fifteen years that the plan was in operation, that was not a period when the plan had to react to a large number of claims. During the years since 1982, when the many problems have arisen, I was not part of the management team.

I have been very surprised to see apparently nothing in public debate recognizing the effectiveness of the plan and the skill and efficiency with which it has operated to meet the depositors' claims that have arisen. I regard it as having been highly successful.

Correcting incentive problems in deposit insurance: the range of alternative solutions

Edward J. Kane

In the United States, federal deposit insurance operates as a disequilibrium system. Explicit premiums are calculated as a fixed percentage of domestic deposits. For the marginal dollar of deposits, this leaves the deposit-insurance agencies (principally the Federal Deposit Insurance Corporation or FDIC and Federal Savings and Loan Insurance Corporation or FSLIC) ready to insure forms of portfolio risk to which they do not apply appropriate administrative penalties on cheaper terms than the market is prepared to pay institutions for assuming these risks in the first place. To offset the subsidy to risk bearing that this structure of explicit premiums creates, deposit-insurance personnel have to monitor client risk-taking and impose a series of administrative penalties (i.e., implicit premiums) on clients that they observe to be taking what shape up as inappropriate risks. This system has two serious weaknesses. First, political restraints inevitably protect particular forms of risk-bearing, such as housing and agricultural loans. Second, inescapable lags in recognizing the risk implications of emerging categories of client risk-taking reward deposit-institution managers for discovering innovative (and therefore unregulated) forms of bearing risk.

Unregulated risks are not only subsidized, they are largely unfunded. The burden of backing up FDIC and FSLIC guarantees falls implicitly on the general taxpayer and on any conservatively man-

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aged institution that chooses to resist the siren call of subsidized opportunities for aggressive risk-bearing.

This study argues that generally accepted accounting principles – which allow deposit institutions to carry underwater assets at historical cost and prevent the value of FDIC and FSLIC guarantees from being booked (i.e., formally entered onto their balance sheets) – routinely distort public perceptions of deposit-institution earnings and capital and understate the cost of the federal government's commitment to bail out troubled banks and savings and loan associations (S&Ls). In the face of an increasingly risky economic environment, the absence of effective taxpayer discipline on regulators and elected politicians who permit the market value of deposit-insurance guarantees to grow leaves the value of these guarantees out of administrative control. Because the distribution of implicit taxpayer responsibilities for redeeming unfunded deposit-insurance guarantees differs sharply from the apparent distribution of the benefits of deposit insurance (which figure to be greatest for the stockholders and creditors of very large institutions), this lack of control is not politically sustainable.

Whenever opportunities for institutional risk-exposure expand, lags in regulatory response permit the deposit-insurance subsidy to risk-taking to grow, increasing the fragility of our financial system. To cut back incentives for voluntary risk-taking, it is necessary to reprice and to redesign the existing system of deposit-insurance coverage. The FDIC and FSLIC must develop incentive-compatible insurance contracts and monitoring arrangements and price their guarantees fairly. Under current arrangements, low-risk deposit institutions are asked to pay unreasonably high premiums for deposit insurance, while high-risk institutions are offered bargain rates. To limit insured institutions' opportunities for adverse risk selection, contractual incentives need to be established to allow a would-be low-risk institution to lower its effective premium by communicating the confidential information that its own managers possess about the institution's true exposure to both traditional and non-traditional forms of risk.

We may liken the current federal system of deposit insurance to an old and undermaintained automobile that, after years of hard but reliable service, is nearing a serious breakdown. In recent years the deposit-insurance car has become a smoke-belching jalopy that is

being driven at high speeds up and down a series of steep interest-rate mountains and over unpaved backroads in agricultural regions of the United States, in less developed countries, and in energy-exploration regions all over the world. Because it has taken so much abuse, the deposit-insurance jalopy ought to be traded in before it lets its passengers down at an inopportune time.

This metaphor has three instructive features. First, let me characterize the CDIC as a 17-year-old replica of a 50-year-old automobile. Second, it implies that the largely trouble-free operation that the US deposit-insurance system delivered during its first forty or fifty years is of no current relevance. In ignoring the momentum of the system, defenders of the status quo act like a pair of government building inspectors that accidentally tumbled off the roof of a sixty-storey building. Devoted to duty until the very end, as they fell past the top fifty floors, they loudly reassured each other and the building's occupants, 'So far, so good.' Whatever good the system has accomplished in the past, politicians and taxpayers need to recognize that its momentum is propelling it in the direction of a bureaucratic disaster exemplified by the breakdown of the Ohio system for guaranteeing seventy-one S&Ls in March 1985. When the Ohio Deposit Guaranty Fund (ODGF) was exhausted by a single failure, state authorities for a few weeks resisted political pressure to supply credible guarantees for the other seventy institutions or to indemnify the FSLIC for taking over the ODGF's liabilities. This led to serious runs on the weakest of the survivors, which frightened state authorities sufficiently to call a banking holiday that temporarily shook confidence in state-insured S&Ls and even federally insured thrifts in the rest of the country. Unless market discipline is reimposed on deposit institution risk-taking, the federal deposit insurance bureaucracy is eventually going to encounter similarly mismanageable obstacles. Eventually, one of these will be mishandled badly enough to call the credibility of federal guarantees into question.

Third, it is instructive to liken the problem of selecting a new framework for deposit insurance to the process of shopping for a new car. Given dealer prices, the main question is what features to ask the dealer to install on the new-model insurance system – either immediately or in stages. Options available on both insurance contracts and cars expand secularly. Cruise control, pneumatic shock absorbers, power steering, power brakes, automatic transmission,

power locks, power antennas, and remote releases for hood, trunk and gas caps did not even exist in 1933. Systems of risk appraisal, risk sharing, and risk management have improved in parallel fashion. After years of driving an antiquated car, a potential buyer needs guidance as to which of many apparently luxury options a contemporary driver should regard as practical necessities. This paper's program for deposit-insurance reform is conceived as a six-category catalogue of optional technological improvements that knowledgeable federal taxpayers might ask politicians to include on the new deposit-insurance invoice.

In an economic environment in which deposit institutions are highly levered and entering new businesses every day and in which interest rates are highly volatile, systematically mispricing deposit-insurance guarantees encourages deposit-institution managers to position their firms on the edge of financial disaster. Metaphorically, deposit-insurance authorities are paying deposit-institution managers to overload the deposit-insurance jalopy, to drive it too fast, and even to breakdance on its hood as it careens through interest-rate mountains and over back-country roads. Reformers' ultimate goal must be to confront institutions whose risk-taking imposes socially unacceptable risks on its federal guarantors with a combination of reduced coverages and increased fees sufficient to move them to adopt safer modes of operation. Their proximate aim should be to make the FDIC and FSLIC act more like private insurers, so that they better protect their and federal taxpayers' economic interests, treat large and small institutions more equally, and make stockholders and uninsured creditors (including large depositors) bear more of the risk inherent in deposit-institution operations. This probably involves making much more room for private and even interagency competition in the provision of deposit insurance.

While politicians and regulators prefer to minimize failures during their term in office, to control deposit-institution risk-taking over the long run it is necessary to expand opportunities for troubled individual institutions to experience runs and even to fail. Economic analysis indicates that as deposit-institution managers and customers more fully appreciate the extent of implicit or de facto federal guarantees, continuing to rescue insolvent firms becomes counterproductive. In the long run, regulatory efforts to prevent de facto deposit-institution insolvencies from becoming de jure

insolvencies increase the size and extent of de facto insolvencies in the depository industry.

SIX-POINT CATALOGUE FOR DEPOSIT-INSURANCE REFORM

The adjustments needed must include at least some of six basic changes in federal deposit-insurance contracts (Kane 1983). Viewing these proposals as six desirable features available to purchasers of new-model automobiles should clarify that this program is not conceived as an all-or-nothing package. Although the various elements in the package complement each other, adopting any subset of the reforms suggested should provide a better deposit-insurance system, one whose operation would be smoothed by the improved system of risk-taking incentives.

Market-value accounting

The heart of various deposit-insurance dilemmas is that a deposit institution's managers have more and better information about the riskiness of their firm's operations than its insurers and customers do. Since 1938, generally accepted accounting principles and regulator-imposed accounting rules have authorized deposit institutions to employ so-called intrinsic-value accounting, which permits assets to be carried at book value as long as their scheduled cash flows remain relatively current. Reinstituting market-value accounting for deposit-institution loans and investments can be justified as an administratively cheap scheme for raising the implicit regulatory premium on deposit insurance in a risk-sensitive way. The most attractive aspect of this approach is that it makes traditional capital requirements and other implicit premiums more effective, while letting market forces help bureaucrats to conduct regular assessments of an institution's risk exposure and to impose appropriate penalties on overly aggressive risk takers.

That muggers and burglars prefer to work in the dark is reason enough to propose brighter lighting. In a world where declines in market value are not obscured by book-value accounting, deposit-institution managers who contemplate aggressively pursuing unregulated risks would know that they would have to defend their risk-taking strategies against regulator and financial-analyst criticism and to offer correspondingly higher interest rates to uninsured

depositors. Moreover, when and if these risks go awry, they would face quicker and more extensive damage to their careers and to the stock price and deposit flows of the institution they manage.

Contemporary accounting principles relieve managers that report book values from legal liability (and absolve their outside accountants as well) for communicating less than their best estimate of the value of an institution's portfolio. Legal authority to use book-value accounting to cover up adverse information flows gives financial-institution managers (especially unscrupulous ones) too much discretion over the extent to which current problems show up on an institution's income statement and balance sheet. This managerial discretion puts the burden of valuing deposit institutions on financial analysts and weakens the effect of market and political controls that would otherwise discipline institutions' and insurers' risk exposure. Having to worry about how insurers and depositors might respond to quick-breaking news about potentially injurious developments would establish incentives for deposit-institution managers to modify and to bond their behaviour in helpful ways. Even after the FDIC issued blanket guarantees of Continental Illinois liabilities in May 1984, institutional investors governed by prudent-man rules continued to withdraw maturing funds from the bank. The bank's market for letters of credit dried up as well.

If private parties are to bear more of the risk inherent in a de jure failure, accountants owe investors in deposit institutions and co-insuring depositors (those that are less than fully insured) a best-efforts estimate of the risk exposure and changing market value of the assets and liabilities that deposit institutions hold on their books. Investors and insurers need reliable information on the value of unrealized losses and gains at financial institutions, information of the sort that conscientious deposit-institution managers should be assembling and analysing in the course of operating their firms. To produce estimates that would be accurate to within a few percentage points of market value, accountants need only to supplement their more traditional bean-counting skills by developing and deploying a reasonable competence in asset appraisal. As in real-estate appraisal, to value an asset that does not trade, an analyst must rely heavily on data covering current yields and prices in secondary markets for comparable investments. For an institution as a whole, as long as

unbiased appraisal techniques are employed, errors in valuing the individual assets in its portfolio should tend to cancel out.

To estimate the value of mortgages and directly placed loans (such as those to troubled farmers, energy firms, and less developed countries), the major problem is to assess the reliability of lender projections of future cash flows and to obtain reliable estimates of appropriate market discount rates to use as inputs into present-value formulas. Practical implementation of these formulas has been greatly simplified by software that pre-programs the necessary calculations onto floppy discs or hardwires them into the circuits of hand-held calculators.

If federal deposit insurers wanted to develop rather than to conceal such information, they could expand the set of transactions observed in secondary markets. Specifically, they could request their liquidation divisions to arrange for periodic auctions of assets chosen for their inherent comparability to the most important classes of hard-to-value instruments currently being held by troubled institutions. They could also set up a self- regulatory valuation standards board.

Until very recently, neither government nor industry has wanted to publicize base-line values for troubled assets. Although we may cite some tentative administrative steps in the direction of greater disclosure, backsliding continues to occur with respect to politically protected risks. On the plus side, authorities have required banks to report their positions in troubled foreign loans and required S&Ls to report gaps between the interest sensitivity of their assets and liabilities. In 1984, the SEC and Comptroller of the Currency specifically forced several large institutions to restate their 1983-84 profits in a less self-serving manner. However, authorities have encouraged cosmetic accounting by permitting problem loans to less developed countries to be carried at book value and by promising to take a 'flexible' approach to valuing distressed farm loans at banks located in agricultural regions.

Opponents of greater disclosure offer two objections: first, that the costs of providing market appraisals might exceed the benefits, and second, that outside parties might dangerously misinterpret the accounting reports that result. Even though market-value accounting promises to increase the costs and complexity of outside audits, it should improve decision making at any firm whose internal information system does not already employ market-value data. In

addition, by simplifying the tasks of financial analysis and of deposit-institution examination, it should release appreciable amounts of resources elsewhere in the financial industry. Opponents of market-value accounting worry that it will increase fluctuations in reported earnings; however, by making changes in the portfolio values public, it creates incentives for managers to adopt policies that make the true value of these fluctuations smaller. Moreover, because capital markets must estimate current values in any case, better estimates of portfolio values should reduce (at least on average) the size of allowances that market participants make for the uncertain cosmetic nature of reports of institutional earnings and capital positions. Today, the need to allow for the degree of managerial artfulness permitted in assembling information for reports prepared under principles of historical-cost accounting makes investors discount the reported earnings of even conservatively managed institutions.

On the regulatory side, market-value accounting should help deposit insurers to discover problem situations more quickly and generate popular pressure on authorities to make more timely and better-focused interventions. As long as deposit-insurance agencies remain free to offer capital assistance to failing clients, market-value accounting would merely curtail rather than eliminate regulatory discretion as to whether and when to close an economically insolvent institution. However, by forcing more timely and more explicit forms of intervention, market-value accounting would reduce an insolvent institution's opportunities for pursuing go-for-broke strategies.

Accounting standards that make it ethical for individual deposit institutions to disguise insolvency and risk-taking beyond all recognition greatly undermine the effectiveness of existing capital requirements. Until these standards are changed, proposals to solve the deposit insurance problem by raising or restructuring deposit-institution capital requirements threaten to prove self-defeating.

Expanded opportunities to manage risk exposure

To neutralize political pressure for forbearance, deposit insurance agencies need enhanced rights and a greater determination to take timely action on three fronts: to force institutions to maintain the market value of their capital accounts, to cancel the insurance coverage of aggressively managed institutions, and to foreclose on the bank's charter before the market value of an institution's net worth is

exhausted. The goal of this class of reforms is to make the current disequilibrium system less prone to breakdown by making it easier to prevent institutions that are insolvent de facto from making spectacularly risky endgame plays with FDIC and FSLIC (i.e., taxpayer) money. In recent years, so many failing institutions have made last-ditch manœuvres with insured brokered funds that aggressive deposit brokers appear to do a better job of identifying insolvent institutions than FDIC and FSLIC examiners do.

Of course, because insurers may track the same data on CD yields to which customers of CD brokers respond, this appearance is illusory. The jibe has force only because problem situations persist long after the desirability of preserving FDIC and FSLIC insurance reserves should have led the insurer to demand an institution's closure. This delay, which intensifies agency exposure to go-for-broke speculation by failing firms, traces in part to statutory constraints on FDIC and FSLIC problem-solving options. Unlike automobile insurers who routinely cancel their coverage of drivers they deem to be poor risks, the deposit-insurance agencies do not have the right to terminate an institution's insurance on short notice. For example, unless a problem bank neglects to exercise some of its rights of appeal, it takes the FDIC a year to start to terminate its insurance of new deposits, while the process of fully phasing out its guarantees on a bank's existing deposits absorbs two more years. In 1983, the FDIC initiated a record-high twenty-six termination-of-insurance proceedings.

Nor do insurers have the right to close an institution they deem legally or economically insolvent. They may, of course, petition the institution's federal or state chartering authority to declare a legal insolvency. However, the interests of this second agency in resolving the problem typically differ importantly from that of the insurer. For federal S&Ls and some federal savings banks, this tension is contained within a single building, as the Federal Home Loan Bank Board (FHLBB) balances the narrow economic interest of the FSLIC against broader political concerns that affect the Board. However, whenever an insured S&L holds a state charter, its chartering authority must also be brought into the negotiations. For the FDIC, conflicts of interest also vary with the character of the regulatory climate chosen by the client. For national banks, the primary regulator and chartering authority is the Comptroller of the Currency. (However, in December 1983, the Comptroller agreed to give the FDIC blanket

authority to examine all national banks whose condition falls in the lowest two categories of the agencies' five-point rating scale.) For FDIC-insured federal savings banks, the FHLBB holds regulatory and chartering authority. For state-chartered commercial banks that belong to the Federal Reserve System, the Fed is the primary federal regulator, but not the chartering authority. This means that, to close such a bank, the FDIC must rely on information developed by the Fed and deal with both its state banking commissioner and officials from the Fed.

For the banks it examines itself (i.e., insured state-chartered nonmember banks and mutual savings banks), the FDIC may issue cease-and-desist orders against specific practices it deems improper, remove bank officers who engage in substantial violations of laws, regulations, or sound banking practices, and even levy civil monetary penalties. For federal supervision of other insured banks, it must rely on the Fed and the Office of the Comptroller of the Currency to take parallel enforcement actions. During the early 1980s, the number of such actions has increased with the number of problem banks.

Because the effects of formally shutting down an institution are effectively irreversible, requiring that an independent agency concur in advance with an insurer's decision to declare a bank insolvent has the benefit of protecting deposit-institution customers, managers, creditors, and stockholders against abusive uses of FDIC or FSLIC regulatory authority. However, given that injured parties retain the right to sue for damages *ex post*, this benefit should be weighed against the costs that systematically delaying the failure of moribund firms visits on the taxpayer. The benefits of requiring the FDIC and FSLIC to win the assent of other federal regulators merely to alter the level and composition of capital requirements or to update procedures for monitoring client institutions are even more questionable.

Insurer rights could be strengthened in many ways. By far the simplest approach would be to consolidate federal deposit-institution regulatory functions wholly, or at least primarily, in the federal deposit-insurance agencies. However, this approach would reduce the bureaucratic dominions of the Federal Reserve System and the Comptroller of the Currency and threaten job opportunities for identifiable groups of these agencies' employees. Maintaining that their supervisory functions are essential to their greater missions, each agency's leadership is prepared to lobby vigorously to retain them.

Because the weight of the Fed's macroeconomic responsibilities gives it extraordinary clout in Congress, the chances of transferring its regulatory powers to the FDIC are minuscule.

Treating the structural partition of federal supervisory authority as a given, Congress has been willing to entertain proposals to increase the authority of the federal insurance agencies to examine insured institutions, to reduce procedural delays in terminating insurance, and to impose further regulatory and civil sanctions on institutions whose managers engage in abusive practices. However, in the absence of a perceived legislative crisis, deposit institutions may be expected to lobby effectively to prevent applicable sanctions and statutory redefinitions of abusive practices from gaining much sweep.

Even without new powers, the FDIC and FSLIC should adopt policies that commit them more determinedly to protecting these agencies' narrow economic interests. Only when economic pressure against their reserve funds became severe did FDIC and FSLIC officials systematically begin to take administrative actions designed to foster uncertainty about the extent of their de facto commitment to rescue uninsured creditors.

The most important of these administrative actions was to develop a new technique for resolving failures that is known as the deposit transfer or modified payoff. In one variant of these transactions, the insurer sells only a failing firm's insured deposits to an acquiring institution and leases rather than sells the dead institution's premises and equipment to the acquirer. In several 1983-4 failures, the FDIC's approach was to sell the acquiring institution only the sum of the failed firm's insured deposits and its estimate of the percentage of uninsured deposits that the FDIC would recover in liquidating the firm's portfolio. If not overruled by the courts, this technique promises to make uninsured creditors take their lumps in liquidation without unduly disrupting the financial lives of a failed institution's insured customers.

However, when the use of this technique helped to increase uninsured depositors' anxiety about the viability of Continental Illinois, it was at least temporarily abandoned. In the long run, I believe that it will prove regrettable that the essentially political advantages of preserving the accounting value of FDIC reserves persuaded the agency against using some variant of the modified-payoff technique to resolve the multibillion-dollar insolvency of

Continental Illinois. Whatever the short-run benefits of shoring up the agency's insurance reserves and sharply arresting the spread of depositor pressure to other large banks, destabilizing precedents have been set by permitting an insurer to issue de jure guarantees of both the claims of Continental's uninsured creditors and the debt of its parent holding company. Paying uninsured creditors of the bank 98 cents on the dollar could have controlled contagion at much less expense to federal taxpayers.

The precedent set by this bailout undermines the potential effectiveness of the FDIC's current proposal to raise capital requirements sharply for client banks, while permitting banks to raise the incremental funds by means of subordinated debt or debt sold to a parent holding company (Silverberg 1985). To the extent that debtholders feel themselves to be in line for a bailout in the event the bank's ordinary equity is exhausted, they will not hold out for a risk premium high enough to bring risk-taking under control. Because the conjectural probability of bail-outs increases with the size of the bank being financed, this approach would reinforce the de facto discrimination in the perfection of deposit-insurance guarantees available to large and small institutions.

A second category of administrative action has focused on reducing the size of the endgame play that an insolvent institution can make between successive examination dates. The proximate goal of this line of action is to limit the ability of brokers in certificates of deposit (CDs) to pyramid the $100,000 insurance coverage granted individual depositors to create large blocks of fully insured funds. In early 1984, the FDIC and FSLIC proposed to limit insurance coverage on the aggregate of funds placed in any single institution through any one broker to $100,000. They were forced to backtrack from this initial proposal both by lobbying pressure that CD brokers channelled through Congress and by the federal courts. A June 1984 ruling in US district court, affirmed by the US Court of Appeals in January 1985, upheld a legal challenge that the brokerage industry filed against their action. Related proposals under active FDIC consideration include dropping its coverage of any deposits owned by financial institutions and eliminating various forms of trusteed accounts' rights to what has amounted to virtually unlimited coverage. Both proposals are aimed at closing loopholes through which a CD broker could almost

costlessly circumvent FDIC and FSLIC efforts to control the proliferation of brokered funds in failing institutions.

On the issue of brokered deposits, the FDIC's and FSLIC's only victory so far has been to increase reporting frequencies for institutions that rely heavily on brokered deposits. Since August 1984, FDIC-insured banks have been required to file monthly reports and to be prepared to submit to sudden examination whenever 5 per cent or more of their deposits come from CD brokers. This asymmetric data-gathering requirement underscores the inadequacy of the FDIC's and FSLIC's ordinary information systems. Insurers' information systems have notably lagged behind those operated by large well-managed commercial banks. As more deposit institutions adopt electronic record-keeping and as telecommunications systems improve, more frequent and more extensive readings of clients' electronic balance sheets become increasingly less burdensome. With a more adequate information base, agency asset-liability committees (ALCOs) could be set up to manage each agency's aggregate exposure to interest-volatility, industry, and country risk.

Recalibration of insurance coverages

The economic value of a dollar of deposit insurance varies in two ways: (1) at a given institution, it varies with the type of account covered, and (2) for a given type of account, it varies with the riskiness of the portfolio policies followed at the institution that issues the deposits. As a complementary way of improving insurers' information flow, Congress should permit deposit insurers to alter their coverages and fee structure to generate information on an individual institution's own perception of the benefits it reaps from insuring different types of accounts in different ways. As we noted earlier, deposit insurers and uninsured creditors have less information about an institution's risk exposure than a deposit institution's managers have. By developing a wider-ranging structure of insurance coverages and associated premiums, managerial assessments of the value of different kinds of coverage could be extracted from their willingness and unwillingness to pay a set of carefully varied asking prices for specific coverages. Even more information could be gathered if clients were permitted to switch insurers in pursuit of what they regard as cheaper or more reliable coverages.

Managers' selection of coverages signals how risky they and their customers perceive a given institution to be. Low-risk institutions should operate most profitably with minimal coverages. Money-market mutual funds provide an instance of conservatively managed near-depository institutions that operate effectively without any insurance at all. However, high-risk institutions should be able to compete best when they obtain maximal coverages from one or more extremely reliable insurers. If the representative institution were to demand maximal coverages on all account types, we could infer that the price of each type of insurance is too low across the board and that risk-bearing is being subsidized industry-wide.

What is needed is a strategy for assembling information on which a reliable process of risk-rating could be based. While it seems appropriate to leave detailed planning to insurance specialists, as a start I would recommend three changes in contract provisions:

1 Lowering (perhaps gradually) the basic coverage per account to a level sufficient to protect the transactions and precautionary balances of most household customers. An upper limit of $10,000 is particularly attractive, inasmuch as this is the minimum denomination on US Treasury bills, which stand as a close substitute for large-denomination holdings of insured deposits. If such a limit is adopted, future values of the ceiling should simultaneously be indexed for inflation to make it more difficult for lobbying pressure to reintroduce the real value of maximum account coverage into the political arena. Congress needs to recognize that its decision in 1980 to increase account coverage to $100,000 was a serious mistake that it should strive to rectify as soon as possible. Fully insuring large-denomination deposits effectively permits banks to issue high-denomination federally guaranteed debt that in divisibility and liquidity is actually superior to ordinary Treasury securities.

2 Differentially pricing successive layers of optional supplementary coverages (offered, say, in $10,000 slices) and adjusting these prices in accordance with market principles. These coverages could be purchased either by institutions acting for holders of specific classes of deposit accounts or by individual depositors acting on their own. Market-based pricing would seek to cover the implicit and explicit costs of producing FDIC and FSLIC insurance services at the level of client demand served. The aptness of the prices charged could be

tested by laying off some or all of these contracts in the secondary market for what is called reinsurance.

3 Introducing provisions for deductible and coinsurance elements into this supplementary coverage. In introducing these elements, authorities could investigate the effects of relating progressive declines in coverage directly to account size and inversely to an account's maturity.

A complementary action would be to impose cumulative lifetime limits on the collectability of an individual or institutional depositor's aggregate claims on the federal deposit-insurance agencies. Adopting cumulative ceilings would parallel the coverage patterns employed in underwriting major medical insurance, making it important for even fully insured depositors to 'care' whether CD brokers transfer their funds into insolvent institutions.

Opponents emphasize that these adjustments would penalize large depositors and increase deposit-institution funding costs. The other side of this criticism is that the existing pattern of subsidies is anti-egalitarian welfare for large depositors, who can afford to buy nominally risk-free debt in large denominations directly from the Treasury. Taxpayers as a whole would benefit from reducing the true cost to government entities of underwriting deposit-institution risk-taking.

Risk-rated explicit premiums

Risk rating is the process of analysing and pricing the risk exposure inherent in a particular insurance contract. Explicit insurance premiums are fees that clients pay in the coin of the realm. The major benefit from realigning deposit-insurance coverage would be to produce information that an insurer could use to develop a premium structure that would curtail its exposure to moral hazard. Risk-sensitive explicit pricing is needed to relegate to a lesser role *ex ante* implicit premiums on previously recognized forms of risk-taking.

Risk-rated explicit premiums need not consist entirely of *ex ante* payments. Such payments may include procedures for an *ex post* settling up of gains and losses between an insured institution, its stockholders, and the insurer. To lessen the incentive for last-ditch gambles, *ex post* settlement schemes could include provisions for

extending the limited liability of the stockholders of a failed institution or even of the stockholders of its parent holding company (as in the double or triple liability that used to apply to holders of a bank's stock) or to give the insurer the right to claim an appropriate share of any gains that a client reaps from forms of risk-taking that FDIC or FSLIC policy statements declare to have been abusive.

If a firm records the market value of every other item on its expanded balance sheet, including sources of value that current accounting principles designate as off-balance-sheet or unbookable items, the value of federal guarantee services to an individual firm can be calculated as a residual from the value that the stock market places on the equity of the firm. In principle, a firm's stock value, S, equals the market value of bookable and unbookable assets, $A+A'$, minus the market value of bookable and unbookable nonequity liabilities, $L+L'$. If every other off-balance-sheet source of value is accounted for, the value of a firm's explicit and conjectural federal guarantees net of discounted future premiums, F_{CG}, may be calculated as: $F_{CG} = S-(A+A')+(L+L')$. The annual cost of providing this guarantee, $C(F_{CG})$, may be defined as the interest cost of supporting the average value the guarantee has during the year, $i_tF_{CG}(t)$, plus the change in the market value that occurs from year-end to year-end: $C(F_{CG}) = i_tF_{CG}(t) + F_{CG}(t) - F_{CG}(t-1)$. If the liability of stockholders in every financial institution that enjoys a conjectural guarantee were extended to two (or more) times the par value of their stockholdings, as the liability of stockholders in national banks was until 1959, quarterly or annual charges designed to recover this cost could be levied on an *ex post* basis. Moreover, such a scheme could price away the unfair advantage enjoyed by banks that are perceived to be too large for regulators to liquidate.

The many opponents of risk-rating emphasize that setting *ex ante* premiums or designing an equitable scheme for *ex post* settling up is a difficult task, requiring a considerably larger information base than is collected today (Horvitz 1983). However difficult it may be for isolated teams of regulators, it is not beyond the capability of modern methods of contingent-contract writing and information processing. As Pyle (1984) points out, corporate bond markets undertake similar kinds of risk assessments every trading day. These risk assessments are demonstrably more difficult to perform than others done by private insurance companies. Modern insurance companies price many exotic

forms of risk, including damages visited on insured parties by computer crime, divorce, cancer, tax audits, and space debris. No matter how great the practical difficulties of rating a deposit institution's risk exposure, the current approach is defective in principle. To maintain permanently an unfunded system that insures risk borne by deposit institutions at a price that lies far below the return offered in capital markets for risk-bearing services is to establish a kind of Ponzi scheme. The longer such a system remains in place, the more severely it will be tested. As time passes, individual institutions become more fully aware of opportunities for exploiting the situation and develop less compunction about seeking to take advantage of them.

Although *ex post* settlement and extended stockholder liability would be administratively easier than *ex ante* pricing, these concepts frighten many deposit-institution managers. They point out that a return to double or triple liability on deposit-institution stock would raise the cost of raising private equity capital. They also express concern that FDIC and FSLIC policy statements could degenerate into devices for bringing political influence to bear on institutions' lending priorities. To make sure that these policy statements serve only the purpose of ruling out such demonstrably dangerous activities as betting an institution's very survival on the future course of interest rates or on the success of particular types of investment projects, it would be useful to assign the task of defining abuses to a self-regulatory organization: an independent deposit-insurance standards board made up of leading practitioners and industry analysts.

What makes risk-sensitive pricing such a hard task is the essential fluidity of opportunities to take risk in financial markets. An institution's adaptive efficiency may be defined as its organizational resourcefulness, which reflects its managers' capacity to think deeply about simple problems and the flexibility they show in adjusting their administrative structure and procedures to cope with sudden or rapid change. To keep risk ratings and insurance premiums current requires considerable adaptive efficiency. For this reason, it seems dangerous to assign the function wholly to government officials. This leads to the fifth option in my program.

Mixed private and governmental competition in deposit insurance

To enhance incentives for desposit-insurance agencies to maximize their adaptive efficiency, it is necessary to provide opportunities for the FDIC and FSLIC to compete with each other (Benston 1983) and for private firms to issue or to reinsure at least some layers of supplementary deposit-insurance coverage. To neutralize political pressure for low prices and uneconomic coverages, authorities must invite into the contract-design and contract-pricing process decision makers whose only stakes are economic-parties whose jobs and firms can and will be wiped out if they issue contracts that fail to make it a client's own best interest to keep its risk exposure within prudent bounds.

Private firms may be counted on to enter any business in which they can anticipate earning a fair return. As if to demonstrate this proposition, during the 1980s private insurance companies began to nibble eagerly around the edges of the deposit-insurance market. So far, they have focused principally on offering supplementary guarantees for individual account holders that, beginning where federal guarantees stop, greatly extend the size of the balance covered. Such insurance is particularly attractive to non-depository institutions such as brokerage firms and insurance companies seeking to market new-fangled substitutes for ordinary deposits. One notable example is Aetna's provision of supplementary guarantees that operate on top of the Securities Investor Protection Corporation's $500,000 basic guarantee to lift coverage for any holder of a Merrill Lynch cash-management account to $10 million. Also, two money-market funds have secured coverage for their customers: one from St. Paul Money Fund Inc. in Minnesota and the other from the Travelers Corporation of Hartford. In a more exotic vein, Cigna Corporation temporarily issued Citicorp $900 million worth of insurance against the risk of currency incovertibility in five countries. The policies covered the contingency that scheduled repayments by debtors in Argentina, Brazil, Mexico, Venezuela, and the Philippines would fail to be remitted because their governments might decide against permitting local currency to be converted into dollars. The contracts included a deductible equal to 25 per cent of Citicorp's exposure in each country and a six-month delay before any unremitted debt proceeds could be collected. Affirming the interest of other segments of the industry, Cigna claimed that it would reinsure over 95 per cent of the coverage.

While private insurance of deposit-institution risks should continue to grow as long as Congress requires the deposit-insurance agencies to maintain unrealistically low explicit premiums, the core of federal insurers' business will remain insulated from the discipline of private competition. It is this insulation that enables agency managers to emphasize political and bureaucratic objectives over their need to adapt economically to rapid change.

Statutory constraints on rescues of insolvent institutions

Although deposit-institution regulators profess a sincere belief in the theoretical benefits of market discipline, practical circumstances inevitably make them reluctant to liquidate a large institution. Given the short terms of office that financial regulators enjoy, it makes little sense for them to take an appreciable chance that a spillover of financial pressure will damage other institutions or undermine public confidence in depository institutions as a whole. Why should agency leaders risk ruining their own careers when they can reliably truncate further damage with a readily obtained injection of federal funds and federal guarantees that serve to rescue a failing institution and its creditors from the need to sustain uncomfortable levels of losses? Confirming this analysis, Comptroller of the Currency Todd Conover went so far as to assert in September 1984 that the federal government wouldn't allow any of the nation's eleven largest banks to be liquidated.

To hear the sirens' song without being lured to his death, Ulysses had to arrange to have himself strapped to the mast of his ship. Similarly, the reliable way to lessen the probability that the Fed and federal deposit insurers will routinely bail out large insolvent deposit institutions and (potentially) private deposit-insurance companies is to place statutory limits on their ability to respond to the political and bureaucratic siren call of short-sighted opportunities for using federal resources to rescue firms that are insolvent de facto.

Although any proposal to limit the discretion of deposit-institution regulators is bound to be controversial, the potential for private loss must be strengthened if implicit federal guarantees are to be made imperfect enough for market discipline to operate properly. The first and most important step would be to require that federal deposit-insurance agencies (like private deposit insurers) leave the short-term responsibility for stabilizing the financial system wholly in the hands

of the Federal Reserve, acting in its capacity as lender of last resort. Deposit insurance will not be properly priced as long as bailout responsibilities compromise the economic function of deposit-insurance reserves. Responsibility for stabilizing financial markets should not be crammed into the mission of federal deposit-insurance agencies. Second, even the Federal Reserve's capacity for bailing out insolvent institutions needs to be constrained. Except in the event of a bona fide crisis – as defined by the condition that a given percentage (say, at least 5 per cent) of aggregate deposit-institution assets in a region has been involved in de jure failures within the previous twelve or eighteen months – the Fed should not be allowed to lend funds to an institution whose capital net of the federal guarantee is negative in market value. This would increase the probability that one or two large institutions could fail de jure, but leave the Fed free both to assist a troubled firm to arrange financing from private sources and to arrest a developing run on the system as a whole.

What this reform would not do is to let authorities repeatedly use the mere possibility of a systemic run as a justification for bailing out individual institutions as a matter of course. The policy of routinely bailing out financially devastated institutions imposes enormous unaccounted expense and unrecognized liabilities on the deposit-insurance agencies and through them on taxpayers and conservatively managed competitors who knowingly or unknowingly backstop the limited insurance reserves these agencies hold. As long as large deposit institutions and their creditors may count on drawing federal subsidies to extract themselves from what would otherwise be do-or-die situations, the potentially salutary effects of market discipline have little opportunity to make themselves felt.

THE POLITICAL DILEMMA OF REFORM

Conceived in 1933 as a device for protecting small depositors and bolstering public confidence in financial institutions, the subsequent interplay of political forces has assigned federal deposit insurance a far broader bureaucratic mission. It functions today as a system for implicitly guaranteeing the capacity of the deposit-institution system to make good on all but a small percentage of its outstanding debt. These implicit guarantees purchase the appearance of stability at the cost of undermining the fear of failure that ordinarily leads an institution's creditors to impose market discipline on its risk-taking

activity. They also shift the burden for financing unfavourable outcomes to taxpayers and conservatively managed financial institutions. The result has been a spate of de facto or market-value insolvencies among insured institutions that the US would recognize as a national disaster if politicians had to present the bill for underwriting these insolvencies to the body politic.

To reduce the underwriting bill and to restore market discipline, it is necessary to make deposit-institution creditors fear failure again. To be meaningful, deposit-insurance reform must reduce the flow of subsidies to deposit institutions. It must endeavour to shift the burden of underwriting catastrophic financial risks from the general taxpayer back toward insured institutions and their creditors. We may count upon political forces to see that Congress develops a set of rules that ease the burdens of transition. But before it can do that, it must agree on the nature of the system it wants to put in place for the long run. A better deposit-insurance system must be one that increases the cost to insured institutions of following subsidy-exploiting strategies of funding, lending, and product-line expansion that have seemed very profitable in the past.

Every one of this essay's six varieties of reform promises to complicate the jobs of deposit-insurance bureaucrats and to hurt deposit-institution stockholders, managers, and large account holders to some degree. Because they see the need to restore financial stability, most of these parties support deposit-insurance reform in principle. But individually they support and oppose different combinations of the six reforms. Industry trade associations must be expected to lobby vigorously against any subset of the six proposals that in the judgement of their membership threatens to hit the firms they represent with disproportionate force. This leaves every one of the six proposals with important enemies and with virtually no important friends.

Each trade association's greatest fears are that its sector of the deposit institution industry will suffer greatly during the transition to a fairer and sounder system and end up regulated more burdensomely than before. Each wants to minimize the extent to which deposit-insurance reform could reduce the value of its particular type of depository firm. Inasmuch as each association's membership acknowledges the nation's need for deposit-insurance reform, their active resistance to anything but token reform puts them in the position of a banker who decided to consult a psychiatrist about his brother, who

had come to believe he was a chicken. His incessant cackling was upsetting everyone in the household and embarrassing them in front of their friends. The psychiatrist assured the banker that he was a leading expert on fixations of this sort and could cure his brother completely in no more than six sessions of therapy. But rather than being pleased by this news, the banker became more agitated than ever. 'Hold on,' he said. 'We are only complaining about the cackling. No one in the family wants to give up the eggs he lays.'

Deposit institutions are able to harvest eggs from the deposit-insurance system only because their deepest layers of risk-bearing are being unintentionally subsidized. As long as this subsidy continues, incentives exist for managers to bet their firm on the future course of interest rates and on the prosperity of specific projects and geographic areas. Some of these bets must lose, and for the losers nationalization looms as an increasingly likely possibility.

Perhaps the greatest irony of financial regulatory reform in the United States is that a necessary condition for its occurrence – a spectacular scandal or financial crisis – is virtually a sufficient condition for a program of reform that pays too little attention to long-term problems. Although reform seldom occurs outside an environment of perceived crisis, a crisis atmosphere favours short-sighted solutions. In the midst of a crisis, regulators and politicians pay far more attention to the system's immediate difficulties than to its long-run needs. A sympathetic analogy is to consider how hard it would be for a football coach to prepare his team to play its season on dry fields, when fate dictates that its training camp must be held on a quagmire.

Today two immediate difficulties frame the problems that regulators see. First, because authorities have proved reluctant to declare de jure failures in the past, the market value of the non-equity liabilities of most deposit institutions exceeds the market value of the assets that they may recognize under generally accepted accounting principles. Second, because of this, the staffs and explicit insurance reserves of the deposit-insurance agencies are overwhelmed. The inadequacy of explicit agency reserves leads agency managers to resort to selling regulatory exemptions and to emphasize non-cash forms of assistance such as income-maintenance agreements and ownership positions. At the same time, staff limitations permit them to discipline only a few of the many institutions that engage in excessive risk-taking. These constraints make it hard for the average

number of de jure failures to exceed two a week, while the pricing of deposit insurance continues to lead hundreds of insolvent deposit-institution managers to pursue a go-for-broke strategy.

It is not necessary for Congress to incorporate all of this paper's six options into the new-model deposit-insurance system. Nor is it necessary that the options finally chosen be installed all at once. Although the complete package probably would produce the best results, adopting any subset of the six options would result in a system that in future years would operate with greater safety, reliability, and comfort. Of course, just how safe, reliable, and comfortable a ride the nation would ultimately enjoy depends also on the macroeconomic policies that the government follows. If Congress could bring government spending under long-run restraint, monetary policy would not have to push interest rates over so wide a cycle. Reducing the volatility of interest rates would relieve the car's drivers of the need to take it over quite so dangerous a set of roads.

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Comments

Robert M. MacIntosh

This conference is taking place on the eve of the publication of the Wyman Report on the Canada Deposit Insurance Corporation (CDIC). It is particularly disappointing that the Wyman Report is not available to us today, because it leaves us talking in a vacuum. My guess is that the delay in public release of the report may have something to do with the federal budget to be presented later today.

The fact that it has not been released also makes it difficult to comment on the McDougall Green Paper on financial institutions in Canada. The discussion paper itself identified concerns about solvency as one of the basic principles, but did not deal with the subject. Thus far, all we have available is the discussion about the organization of the asset side of financial institutions, with nothing about the liability side. Since the two obviously have to be taken together, we really only have half the story.

Not having seen the Wyman Report, I approach the two papers presented today with unaccustomed caution. And, even if the Wyman Report were available, there is the additional consideration that any observer of the financial situation in Canada could unintentionally aggravate current problems. For these reasons, I am going to revert to my original occupation as professor of economics.

There could hardly be a greater contrast between two points of view than between those of Professor Kane and Mr Humphrys. Kane argues for market incentives and market penalties for imprudent management. There are so many quotable quotes that I agree with in

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his text that I am encouraged to believe that the Canadian Bankers' Association's (CBA's) brief on deposit insurance will be seen as having some intrinsic merit rather than being self-serving.

In contrast, Humphrys' paper is from the point of view of the regulator, with only passing attention being given to market discipline. He does not see much role for the deposit insurance administration in establishing standards, let alone hope for conditions that would allow institutions actually to fail and depositors to take losses. He says at one point, 'It may be that the deposit insurance administration should have some voice,' but then goes on to dismiss this. He says that there is little that the deposit insurance plan can do even though it is exposed to losses, and the job is up to the regulator through tightened controls: 'I think this is a situation that must be accepted if a balanced approach to imposing financial discipline is to be achieved through an effective regulatory system.'

I would question whether financial market discipline can be achieved through regulation. Kane clearly shares this concern. He is talking, of course, in the context of the United States and the situations that have arisen there. At the one extreme has been the case of the Continental Illinois, a very large bank, the deposits of which were gathered very largely in the money purchase market. At the other extreme are the recent failures of the savings and loans institutions in his state of Ohio, and perhaps more recently in Maryland.

The big question in deposit insurance is: when does the failure or threatened failure of a single institution turn into system failure? Obviously, system failure would be unacceptable, but what sets in process a domino effect? The problem is not just the outflow of deposits from the threatened institution. The problem is whether this will be duplicated by deposit runs on other institutions.

The American banking system is not particularly well equipped, from this point of view, with a unit banking system, especially in a state such as Illinois, where branch banking is virtually prohibited. The narrow economic base of the unit banking system makes it essentially more vulnerable than a branch banking system such as that in Canada.

It can only be a matter of surmise as to how far an institutional failure will be translated into system failure. Recently, the rapid erosion of the savings and loans institutions in Ohio and in Maryland led to line-ups in the streets and panic withdrawals. But, of course,

the special characteristic of those institutions is that they did not have federal insurance. The fact that these were distinctive local and regional institutions suggests that containment has not been terribly difficult. There has been a rush to obtain federal insurance, and large New York banks have been invited in to help absorb some of the larger savings and loans.

In the case of Canadian chartered banks, about 99 per cent of bank deposit accounts have balances of under $60,000, the maximum insured by deposit insurance. There are no statistics for the trust companies, so I can speak only for our own industry. Therefore, the possibility of a run on the bank, in terms of personal deposits, really does not exist in Canada. There have been a couple of eccentric cases of very local line-ups to withdraw deposits, but these were based on absurd or irresponsible information and were quickly squelched. The problem in Canada is that the run on deposits does not come from the man on the street but from the large depositor who panics. And the large depositors are not covered by deposit insurance.

It is well known that the banks have opposed a 100 per cent payout of uninsured deposits, on the grounds that this totally defeats the intention of the deposit insurance legislation and could only help to perpetuate ongoing problems in the financial system. That position is, of course, very strongly argued by Professor Kane. If our deposit-taking system in Canada consisted only of large, widely based retail networks, as it did to a large extent when the legislation was passed in 1967, we would perhaps not encounter the problems that have been evident in the United States.

However, we now have quite a number of institutions that are dependent on wholesale money markets for a significant proportion of their resources. If one or more of these get into difficulty, it is a matter of opinion as to whether the problems can be isolated. Sometimes, the argument has been made that the large banks are immune from failure because of their very size, but recent experience in Canada suggests that the determination to prevent failure is by no means confined to the very large banks. If this is indeed a consensus, then we must look to the remedies that will force financial discipline on all the players.

Let us turn for a moment to the alternative remedies suggested by Kane and Humphrys. Kane would introduce co-insurance with a minimum insured level of perhaps $10,000 and a reduction of the

$100,000 ceiling, which he considers to be a mist .e. He has much more faith in the possibilities of risk asset measurement than I have.

In particular, he advocates frequent market valuation of assets, in order to force market discipline on financial institutions. While this is an attractive idea in theory, I see no possibility of its being applicable to deposit-taking institutions here or in the United States. It is all very well to talk about frequent market valuation of corporate securities. But the chartered banks in Canada have $15 billion in loans to small business, and the average loan size is very small – for example, under the Small Business Loans Act, the average is only $28,000. We have $8 billion of loans in the agricultural sector involving several hundred thousand accounts. This is to say nothing of the several million consumer accounts.

Even in the case of a very large corporate loan, I would question the possibility of doing a market valuation. The bond rating services attempt to value the bonds and debentures and transferable liabilities of the larger deposit-taking institutions that have quoted securities in the marketplace. Even here, they have recently been subject to scathing criticism by some of the interested parties in deposit insurance. I do not think I have to elaborate on this response to suggest that Kane's suggestion is simply not practical.

Humphrys says: 'There is no power under the deposit insurance administration to apply any disciplinary measures on member institutions.' He then goes on to argue that the regulatory environment should be tightened, but not in the hands of the CDIC. One of the measures he suggests is a more careful review when charters are granted in the first place. He then makes the statement, 'In practice, such matters are carefully studied and charters are not granted unless it appears that the proposed enterprise has a chance of success.' This is quite an extraordinary statement, considering there are persons still wanted by the police. Humphrys recognizes that control can be transferred subsequently, and he suggests that it ought not to be difficult to assess the suitability of new owners, as to character and trustworthiness. The record in recent years does not give one much cause for comfort.

In his treatment of possible methods for regulating self-dealing and conflict of interest, Humphrys points out that, in the case of the chartered banks, this is accomplished by limiting the degree of ownership. He does not appear to think that this process is necessary

for other deposit-taking institutions. He says that the present federal approach for non-bank financial institutions (NBFIs) is to legislate against conflicts of interest by the decision-making group. He says, 'These provisions have served a reasonable purpose but should, I believe, be strengthened.' If I understand this correctly, he is saying that things have not worked too badly in that regard in Canada. In the interests of academic serenity, I will not comment further on that point of view.

Turning now to points on which I can agree with Humphrys, he says that it is essential to search for some criteria other than conventional financial ratios to give an earlier warning of impending troubles in an institution. He goes on to say that some of the financial ratios should perhaps have been strengthened anyway. He questions whether the loan-to-value ratio for mortgages should have been pushed up as high as 75 per cent, and he points out the need for an effective definition of market value. He looks at capital adequacy ratios and liquidity ratios and finds that these are not sufficient to give early warning.

I think the evidence suggests that, in this regard, he is right, although matters would be greatly improved if all deposit-taking institutions were required to publish quarterly income and balance sheet statements within a short time after the end of the quarter, as do the chartered banks. I am not suggesting that this would solve all problems, as it obviously would not, but it would go some distance toward public disclosure, which is now greatly lacking except for all banks and for the larger trust companies.

In my opinion, with past experience still fresh in the public mind, and with the prospect of better public disclosure of information, markets should be able to do a better job than regulators. Admittedly, this will not always be the case, but, where deposit-taking institutions are raising money in public wholesale markets, I think it is possible to make use of information on interest rates. In a recent paper at a data processing conference, I suggested that there is nothing to prevent the collection of daily information on 30-day deposit rates paid by all financial institutions.

This may sound like a horrendous task, but, in fact, it would be relatively simple. There are 130 or so members of the Canadian Payments Association, not including certain department stores and others, which aspire to be financial institutions. The daily input of

deposit rates would not be difficult to accomplish with our modern computer network. In fact, most large and medium-sized institutions, and even quite small ones, manipulate information on deposit rates not just daily, but at any moment of the day.

It would not take more than a few months' work to institute an information system that could consolidate such data and place them simultaneously on the desks of the CDIC and all the federal and provincial regulators. Perhaps, also, this information should be made available to the public. Where spreads start to widen appreciably – that is, where an institution starts paying well over average market rates for funds – there would be a signal for the regulators to send out a search party.

I am talking about a distant early warning system. It might turn out that the signals were false or insignificant, but it would certainly help to identify, in a hurry, where potential problems might lie.

We have already started collecting such data on a weekly basis in our association, just to prove that it can be done, and our sources are simply weekly newspaper reports from across the country. The information is quite striking, and I have offered it to a couple of the regulators, but I have not heard from them yet.

Humphrys also says, 'Generally speaking, the flow of information thereby achieved is adequate for the purposes of regulation.' And, again, 'Generally speaking, it seems that the information flow now required is adequate but could be supplemented by further specific tests.' In the case of chartered banks, I would like to point out that financial statements for the quarter ended 30 April 1985 are now starting to appear in the press, as required by law. In the case of the trust and loan companies, Humphrys notes that public information is made available in the annual report of the Superintendent of Insurance. He means annual information, and he means a year or more later. Right now, we have the annual report of the superintendent for the year ended 31 December 1983, and that was available to the public only on 1 April 1985. We will never get data on the second quarter of 1985 except for the larger trust and loan companies, but by 1987 we will get data for the year ending in December 1985.

Having in mind Humphrys' general satisfaction with the existing situation, subject to some suggestions for tightening it up, it is not surprising that he says there is little or no role for strengthening the

function of the board of the CDIC. He sees the role of deposit insurance as an adjunct, something pro forma that follows the actions of the regulators. Therefore, it is not surprising that he sees the board of the CDIC as a committee of regulators.

He sees no room for representatives of the insured institutions on the board. Without knowing what the Wyman Report will recommend, I will state only that the structure of the board of the CDIC is unique in the Western world. In the CBA, we have done a fairly extensive study of the composition of deposit insurance boards elsewhere.

In the case of the Canadian provinces, which insure their credit unions and caisses populaires, the composition of the board varies. The Ontario Share and Deposit Insurance Corporation has nine board members: three from the credit unions, six from the private sector, and none from the government. In Quebec, there are three civil servants and two outside persons chosen from the general public. British Columbia's board has three members from the credit union movement and two outsiders with general business and financial expertise.

In the United States, the chairman of the Federal Deposit Insurance Corporation is a full-time person from the private sector. Another board member is chosen from the alternative political party, and a third member is Comptroller of the Currency and a civil servant. In the United Kingdom, a board of seven persons consists of three drawn from the insured institutions and a majority of four civil servants. In the case of Japan, there is a nine-member board, of whom seven are drawn from the insured institutions, and a minority of two are civil servants.

The argument is sometimes made that representatives from the insured institutions would have a conflict of interest in attempting to deal with problem member institutions. That is no doubt true, but does not seem to have stopped deposit insurance boards elsewhere from including representatives of the insured institutions.

Moreover, I would like to point out that the regulators themselves have a conflict of interest, which, in fact, is considerably more serious than that of the insured members. We are reasonably confident in the banking industry that the Wyman Report will have dealt with this subject.

In conclusion, then, I would strongly favour Professor Kane's market-oriented approach to deposit insurance reform. Perhaps he could stay in Canada awhile and give us some ideas on how to get out of the regulatory legacy left by the CDIC takeover of Crown/Greymac/Seaway. As Mr Humphrys knows, having been retained as a consultant for the winding down of those companies, there is still about $1.5 billion of real property to be disposed of. The accountants and lawyers have run up bills of $20 million so far, and an impasse exists between the CDIC and Ontario. This just proves that regulatory problems are no less serious after the demise of insured institutions than before.

Discussion

RICHARD HUMPHRYS: There is of course room for a difference in views on this. I think my attitude about the use of the regulatory system stems in part from my own background, but I am confident that it can work, and I always thought it important to avoid creating another regulatory body. I thought it would be a burden on the industry and would give rise to confusion and delayed decisions. I thought (and I still think) it better to build on the regulatory system we have than to create another. If I am wrong and the regulatory system will not work, I believe that any power given to the deposit insurance corporation is not going to help a lot, because as long as there is discretionary entry into the system, under ministerial control, there is no way that a minister is going to grant a charter and have the deposit insurance corporation immediately nullify it.

You have to work out the standards, certainly within the one jurisdiction, and, as I mentioned earlier, you have to apply those standards in a co-operative way with the other jurisdictions that are involved. It is not a solution merely to create another regulatory body, demand more information, and come up with decisions that may be in conflict with the others.

I did not mention much about the question of capital base. Bob MacIntosh referred to the comments in my paper. On the question of early warning systems and so on, I think we have had a tendency to rely too much on the balance sheet. Having in mind the leverage that now exists, it is quite clear that if a company has to move from a going concern to a wind-up basis, a capital marking of 4 or 5 per cent is simply not enough to prevent loss to uninsured depositors and to the deposit insurance corporation. I think a good deal more emphasis should be placed on the income statement and particularly on the interest spread on the deposit-taking business, on a cash basis, without putting in as income capitalized overdue interest and things like that. If a company cannot make ends meet, cannot get an adequate spread on its deposit business, then there is no hope for it.

Market discipline sounds great, but in my opinion it will not be applied by the depositor. We have a regulatory system. The ordinary depositor and even more the big depositor depend on it, and so you have to make up your mind whether to have a system or not. The market-discipline approach would scrap the regulatory system and go

on risk-related premiums, if that were possible. This is fine in theory, but we have a system. There is no expectation of its being scrapped and so it is there. I think the public is going to depend on it, and whether there is deposit insurance or not I don't see any hope of people calling for financial statements and going through a detailed analysis before they put their salary cheques in at the local bank or trust company.

Runs have occurred. Now they are just minor things like the case that Mr MacIntosh referred to. We have deposit insurance, and even in the early days there were some runs until the public got some confidence in it. That is one thing that the deposit insurance plan has done – stop that kind of panic run, not only on the company in trouble, but related companies. The fact that we have it means that there have not been the runs, and it has been astonishing to me that even uninsured depositors seem to be so little concerned when real financial trouble appears in the newspaper and nobody seems to do anything.

As for public information, I agree there could be more done in the way of quarterly statements by the non-bank deposit-taking institutions. But I should mention that all the data in the statements filed federally are put on the computer network very soon after they are filed, and they are accessible to anyone who has computer resources. Analysts and those who have some sophisticated knowledge need that kind of data. It is available a lot earlier than the year that Bob mentioned. I also think that the statements could be made accessible immediately to those who want to look at them.

I agree with Bob's comments about market value approach. You cannot put an institution in the position of putting its assets at market value without discounting its liabilities. You have to look at the matching position.

I do not underestimate the difficulty of measuring the trustworthiness of people who get charters. It is difficult, but it has to be done. I think Bob said that I thought it was not difficult – that's not so. We do not have the power to control the transfer of ownership now, so some of the things that have happened recently have not been with any blessing from the regulators.

EDWARD KANE: There is a lot I would like to say. First, reformers should be asked only to propose *better* approaches, not perfect ones. Neither of the other speakers expresses much faith in experts' ability

to estimate the market value of non-trading pools of assets and liabilities. However, I have even less faith in the book-value measurements in use today. The issue is one of relative precision.

I see several sources of data from which to generate measurements that ought to improve dramatically on the book-value measurements being published today. One approach is to focus on identifying comparable instruments that do trade. Another is to take advantage of value data created by the growing securitization of direct loans. A third is to ask regulators to arrange auctions of instruments that prove hard to value. A fourth is to focus on the present discounted value of a debtor's debt-servicing capacity, using projected after-tax earnings. Whatever combination of approaches is adopted, some arbitrariness will remain. Some issues will have to be settled by some kind of appraisal standards board. However, the resulting measurements should come closer to true market values than do the historical-cost figures commonly employed today.

I am associated with a US pension fund for college and university employees. This fund periodically values its direct loans on a market-value basis. Many of its long-term loans are made to relatively small institutions, whose debt does not trade. For these assets, the firm uses a pricing system developed by Barr Rosenberg, a former finance professor at Berkeley. This system develops a time series of separate prices for each of the major characteristics that a loan may possess. Historically, analysts have thought of a loan's riskiness as consisting only of its credit risk. But other risks, such as interest-rate risk, apply to any financial instrument. Using data from secondary markets, many of these risks can be priced relatively easily. Pricing the effect of interest volatility on a fixed-rate mortgage may be cited as a classic example. Rosenberg's method prices many salient elements in the character of a loan and in the economic condition of a borrower. His estimates provide a good way to track the net impact of changing events on the value of the loan during the time it is outstanding. Simply looking at the book value of a loan ignores important information that develops after the loan is made.

We should not insist that we need to obtain perfect measurements. But we need to recognize that it is dangerous to use an accounting system that systematically neglects information containing important clues about the condition of the institution.

The second point I want to make is to emphasize that I propose to subject both asset and liability accounts symmetrically to market valuation. I believe in double-entry accounting. I do not suggest that accountants should mark only an institution's assets to their market values.

Some resistance to market-value accounting reflects resistance to change per se. Whenever anyone proposes to change a system of rules that people have become use to, transition costs are often seen more clearly than slower developing benefits. When they are sick, most patients want not just medicine that can help them in the long run, but also medicine that will not taste awful going down. Obviously, in the short run, market-value accounting with the disclosure it implies does not promise to taste good. It is medicine that promises to be difficult to swallow. The fact that it might cure a number of serious problems down the line is not as exciting as the unpleasant fact that it might embarrass many current managers.

Third, Mr MacIntosh indicated that he thought Canada was as far down the road to a deposit-insurance crisis as the United States is. But I can cite a couple of pieces of evidence to the contrary, including differences between the positions he has exposed today and those taken by spokespersons for deposit-institution trade associations in the United States. The Canadian Bankers Association still publicly supports limited account coverage and at the same time professes to be upset by the de facto bailing out of insolvent deposit institutions. The US League of Savings Associations has traditionally wanted increases in account coverage and has supported de facto bailouts. In Canada, whether conjectural guarantees actually exist for large Canadian banks is still being debated. In the United States, top officials acknowledge that some banks are too large to liquidate. In both countries, politicians find the fiction of deposit-insurance limitations important. These limitations keep an option open for authorities, if they wish, not to cover all deposits in one or more large bank failures. But the political process, as it is now constituted in this country and in the United States, makes it hard for a government to exercise such options often, if at all.

Also, I agree with Mr Humphrys that, in talking about runs, authorities tend to visualize an irrational run. But what deposit-institution managers and regulators have to fear is the rational run. In Ohio this March and in Maryland this May, the runs that occurred

were very rational. The largest institution in an insurance system became so insolvent that it wiped out the insurance fund supporting it and other institutions. As news of this firm's problems reached the public, depositors began to line up to withdraw funds both from it and from the several weakest other institutions in the system. They took the trouble of investing their time in long queues to preserve their wealth. In Ohio, the deposit insurance fund first tried to pretend that it could keep even the weakest of its clients in place. When it failed to demonstrate the truth of that claim, politicians pretended for a while that they could easily afford to support all but the largest. When it became clear that even some of these other firms had to be closed at potentially great expense, the governor decided to suspend operations at all seventy-one institutions in the system until he could develop information by which to distinguish reliably the hopelessly insolvent firms from the rest. Some of the seventy-one institutions were strong enough to survive even in the absence of ongoing insurance. If market-value accounting had been in place at the time, these determinations could have been made more quickly and more simply. The strong institutions could have remained open while the weakest were identified and closed.

At the same time in Ohio, six completely uninsured savings and loans prospered during this period. Market discipline had long ago forced them to indicate what their policies and economic condition were. One thrift (founded in 1895) had a firm and well-publicized policy of demanding 35 per cent equity on its mortgage loans, of never making a mortgage loan of more than 15 years, and of insisting on a number of other well-known safeguards. Its cautious approach to mortgage lending preserved its net worth. It was able to gain deposits when state-insured institutions were losing them and safes in which to hold currency became impossible to buy locally.

The loss of confidence spread to other state deposit-insurance systems. In Massachusetts, institutions insured by the state-sponsored corporation came under pressure from March on. In North Carolina, a fairly well-run private deposit-insurance corporation began to take a series of actions to strengthen its system, beginning with urging its clients to apply for federal coverage right away. In Maryland, the governor took the reverse action, claiming that for the Maryland legislature to prepare publicly for a run would itself undermine faith in the Maryland system and cause more trouble than it would save. In

May, Maryland experienced a similar insolvency of the largest institution in its state-sponsored insurance system. North Carolina has not had the collapse Maryland had. I thing this is partly due to the unwillingness of Maryland's authorities to take nasty-tasting medicine in timely fashion.

CHRISTOPHER ROCKER (Chase Manhattan Bank): When I put my hard-earned savings into some form of investment, there is often a friendly agency to give me a rating on that investment, say Moody or Standard and Poors. Alternatively, I can choose to go into low-risk investment in the form of Treasury bills. It seems to me in the case of a bank, there are two forms of financial activity. One form is where you are seeking an investment to make a return on your savings account, or whatever it is, with the bank. The other is where you are running a current account of some kind. The latter case is something you are forced to do, it seems to me. You have no option, if you want to act in a financially sophisticated fashion.

The question I would raise is whether what we really ought to be insuring are those current-account, operating-account kinds of activities that people engage in. As far as the other forms of banking activity – the investment form of banking activity – why not have some kind of agency that runs a series of ratios on various banks in the country and produce a rating for each of the banks? Then you could decide whether you are getting your money's worth. If you want to invest in a class-15 bank when the rating is 1 to 15, then you can do so for a higher return and know what risk you are running.

ROBERT MacINTOSH: I don't think you can define the deposit base in this country in terms of current accounts and savings accounts. In fact, one big area where we need an exception to the $60,000 limit is RRSPs. We have seen this arising in the case of Pioneer Trust, and it could arise in the future. We would like to see a lowering of the ceiling on co-insurance from $20,000 to $10,000, but we have to figure out an exception for the RRSPs. Some plans in excess of $60,000 can be held by a not-very-well-to-do family, but it is their life savings, and I really think that we have to look at exempting that in terms of deposit insurance.

As to the feasibility of doing a market measurement, I doubt that it is possible with our present information system. Many of the smaller

institutions have no quoted market values at all; they certainly do not have quoted stock values. We do have bond-rating services that deal with the larger institutions, but there is some question about how good they are. I think they have little depth, quite honestly, in terms of what you would be required to do with the number of institutions we have.

I do think, as I have said, that disclosure ought to be greatly increased in this country. We have quarterly publication for the banks, but the other institutions do not. Some are annual with a lag of two years, not including the big trust companies. I think public information has a lot to do with the assessment of performance institutions. Financial analysts are capable of doing that.

EDWARD KANE: The answer I would give to your main question – why not have credit ratings for many deposit institutions or why the ratings that exist are not more meaningful – is the existence of a deposit insurance guarantee. In many cases there is just not enough customer demand for rating services to justify the expense of preparing a formal rating. Why should depositors care about a deposit institution's capital or even its safety rating, as long as they feel that their funds are comfortably backed up by the insurance they are receiving?

I would also make a point about registered retirement savings plans. It is important to see the redistributional aspects of limitations on who may offer tax-advantaged plans. Any number of institutions could in principle service a savings plan. In the United States, tax-exempt Individual Retirement Accounts (IRAs) may be administered by any financial institution. The only types of organization with federally guaranteed repayment ability are depository institutions. To insurance companies and securities firms, this does not appear to be balanced and fair competition. I can see the value to prospective retirees of having government guarantees of private retirement plans, but I think that guarantees should be available to any plan that accepts an appropriate monitoring and control system and pays proper fees. The guarantee should be not conditional on the type of institutional charter that the sponsor has.

RICHARD HUMPHRYS: I would support that comment in relation to RRSPs because, as Ed Kane says, only the insured deposit institutions

have this protection. Other players in the financial game who compete for the RRSPs do not have this kind of guarantee, so I think it may be a better argument for not insuring RRSPs at all.

ANDRE RYBA: (Economic Council of Canada): I guess I am mostly in agreement with what was said this morning, particularly the analysis of Professor Kane, with one exception. From an economic and legal point of view I think the analysis is overwhelming, but there is one aspect that we may have left aside. Perhaps we economists, probably lawyers as well, are not very comfortable with the concept – a social concept – of social responsibility.

Government has felt that it has a responsibility, a social responsibility, to provide medicare, to provide housing for those who cannot afford it, to provide welfare for those with inadequate incomes. A number of people hold their life's savings in deposits in institutions. They may hold $15,000 to $20,000 and they will have problems in choosing an institution. A speaker yesterday said that he invests in the stock market blindly; he follows basically what his stockbroker tells him to do. I would suggest that a large number of depositors deposit in a bank blindly and would continue to do so even if there were no deposit insurance. My question is: how does social responsibility fit into the analysis?

EDWARD KANE: Social responsibility must have to do with promoting the public interest. To me, the question has always been: what is the public interest? How do we determine what the public interest is in a democracy? The answer is that this is done for us by politics. The political process settles divisive questions for us. Because of the pervasiveness of regulation, economists cannot talk meaningfully about equilibrium in financial markets without considering political feedback.

Regarding the conjectural guarantees of uninsured deposits in the United States and Canada, the political system has done only some superficial work on the issue. It has yet to face up to the truly hard questions. Our responsibility as economists, as government officials, or as lawyers is to educate people – to let them make use of our expertise to identify the issues and to consider in an informed fashion whether they might want to ask politicians to reassess the public interest on this matter.

What concerns me most about government guarantees is their very perfection. It costs so much to drive that last little smidgen of probability down to zero that it cannot possibly be economically efficient to force the probability of loss that low. No one would really want that much protection. There are too many other unavoidable risks in life. It costs a great deal, in terms of foregone market discipline and wasteful allocation of resources, to remove the last little bit of risk from deposit accounts.

ROBERT CLARK: I am in very broad agreement with Professor Kane's recommendations that we move toward a market-oriented system of deposit insurance.

I wanted to try to emphasize some of the problems, from a lawyer's point of view, that will have to be worked out very carefully in moving to that. To be practical, there ought to be provisions for substantial funding of empirical research on predictions of failure in order to develop good actuarial tests. A lot of attention should be paid to how to create incentives or requirements for the regulatory agency, or some part of government that actually does the work. Then we should put the findings to use.

Another thing that is likely to be overlooked is careful attention to the definition of triggering events that generate the rights of the regulators to take action. In other words, we need definitions of insolvency or value and procedures for valuation. I think experience suggests that if this is not done well there will be enormous possibilities for litigation and delay.

Just to follow up on one comment that was made – on the legal definition of insolvency – well, there is no single legal definition – there are literally hundreds, depending on the statute and the context. In the US Federal Bankruptcy Act there are definitions for entry and concepts of insolvency. Very different ones apply in bank insolvency proceedings. The same thing is true of statutes governing creditors' rights, such as the Uniform Fraudulent Conveyance Act, which can be used both in and out of bankruptcy. Some are based on current assets and liabilities, others on balance sheet assets and liabilities. Some are based on contractual ability to pay debt or inability to pay debts that are becoming due. Some are based on market valuations.

The Fraudulent Conveyance Act, for example, defines insolvency in terms of when the fair saleable value of the debtor's assets is judged

insufficient to meet probable liability on existing and future debts as they become due and mature. There are hundreds of cases over the last several hundred years interpreting insolvency for purposes of the Fraudulent Conveyance Act and similar statutes. They show chaos, a mess. You can often have situations where the legal fees spent on litigating such questions consume 30, 40, even 50 per cent of the assets in dispute. This might happen in small creditor-debtor disputes; the figure would not be so high in those involving institutions. This variation and confusion can be a major source of delay for years, even when the court has accepted the most liberal attitude toward using discounted cash flow and other modern techniques of valuation.

A lot of attention has to be paid to defining parameters of procedures to limit the possibilities for litigation and delay and to specifying who decides what rights of review there are or are not and what incentives you can put on parties to restrain this temptation to make it a lawyers' field-day. Otherwise we could lose a large part of the potential benefits.

EDWARD KANE: I agree with this completely. The sad point is that just such a legal mess exists in the United States today. The FDIC had thousands of lawsuits filed against it in 1984. Its fastest-expanding department in terms of personnel is not liquidation – though that area is growing in assets tremendously – but its legal division. This is because it has had to respond to so many lawsuits. Setting parameters for applicable legal procedures is a problem for lawyers to solve, whatever society does about deposit insurance. We need to have all kinds of appeal and review procedures clarified and every party's rights clearly defined. But to do this, we need to agree on first principles. We need to know what our destination is before we can begin to move intelligently at all. All definitions of insolvency for banks (even market-value insolvency) seem to make use of a phrase that Mr MacIntosh cited: 'A firm's ability to service its obligations as they come due or accrue.' Controversy develops over whether 'accrue' should be defined in a broad economic sense, or merely as being likely to come due soon.

PART VIII: SUMMARY

Panel discussion

JACK CARR: For Canada, deposit insurance came in relatively late in the game. It came in in 1967, and we had a system that was operating to some extent relatively well prior to 1967. From 1923 to 1967 there was not a single depositor who lost a dollar of deposit in the Canadian financial system, though there was no deposit insurance. There were cases of mergers, some of them said to be forced, but the system seemed to be operating without any great problems. The first question I want to pose to the panel is: should deposit insurance exist? If so, how should it operate? Is the current system fine? Should we move to a risk-based system? What institutions should be covered by deposit insurance?

GRANT REUBER: My view is that we do need deposit insurance for precisely the reason that Philip Andrewes mentioned. There are a lot of people who put money into a bank or trust company with the full expectation that if they put a dollar in they will get a dollar out. Even if they do not have that expectation, they are very badly equipped to assess the viability of these various institutions.

How to do it? I think a risk-rating that applies a risk premium has a great deal of intellectual appeal. However, as a practical matter it may not be very workable. A more practicable approach might be to provide 100 per cent insurance up to a certain level. Beyond that level there could be an element of co-insurance, possibly 75 per cent by the CDIC and 25 per cent by the customer, with an upper limit, perhaps as now, of $60,000. I think I would exclude from that brokered deposits. In addition, I think we need to be very clear on where these claims stand in relation to other claims on the assets of the deposit-taking institution, if worst comes to worst. To run that kind of system, you clearly need much better regulation than at present. One basic and difficult question is how to handle regulations when you are dealing with a whole range of institutions that come under different jurisdictions. The only answer that I have been able to come up with is to set up a federal system with a set of regulations and regulators who implement, monitor, and supervise the system. Anyone who wants deposit insurance can get it by meeting the regulatory requirements. If they are unable to meet the requirements they cannot get insurance and consequently cannot advertise that they have insured deposits –

unless of course someone else is prepared to provide it. Unless you follow such an approach, I see no way of avoiding the difficult jurisdictional problem.

Other types of institutions also need to be considered. Investment dealers take deposits, as do credit unions. Consideration might be given to saying that any institutions with access to the Canadian Payments Association can have deposit insurance if the requirements of the regulatory system are met. If not, such insurance is not available through the CDIC.

EARL ORSER: First, it has become obvious that certainly our federal government would take the view that it is unthinkable that one of the larger chartered banks should fail. If you start with that point, you then move down the scale and ask, well, what is thinkable in terms of a financial institution failing that would not be rescued by the federal government? I think that there is something fundamental that has to be decided in that realm before we worry too much about the techniques of how to finance and assess a deposit insurance business.

I think that the idea that the life insurance business should have a deposit insurance or some kind of guarantee fund is nothing but a cop-out by the regulators. The profile of our business and our liabilities and our obligations and the way in which our business is regulated suggest that the imposition of some kind of guarantee fund is simply a neat trick by which everybody will pay twice for the same sort of security. I was able to read a little bit of Mr Humphrys' paper and unfortunately was unable to be here to listen to what he had to say, and of course he was the regulator of our business for many years. He too is a little uncertain about the real need for this sort of thing.

I think that today with the kind of technology we have – this would go for the banks and trust companies, too, I suppose – there is no reason why the regulators should not know almost on a real-time basis what the position of the institution is. The regulator should have the authority to make whatever moves that are necessary in an uncertain kind of situation or one in which undesirable things are happening.

BRIAN O'MALLEY: My view would probably represent the smaller trust companies. I doubt that this is unanimous among the other trust companies. There is a large range of types of companies within the

trust industry, as probably most of you are aware. Deposit insurance is a social benefit demanded by the taxpayer, and a politician is naturally going to respond to that demand. The question is not whether we should have it but how much.

Let me take the opposite point of view from some that have been expressed over the last couple of days about how much deposit insurance we should have and whether we should have it on a risk-regulated basis, or whether we should have only some percentage of insurance. If you look at the original premise of deposit insurance, which was to provide $20,000 worth of purchasing power of insurance (in 1967), and look at the effects of inflation over the last 18 years, perhaps deposit insurance should be well over $100,000, or whatever the effect of inflation has been on the original purchasing power that the government agreed to protect.

Small companies now need deposit insurance in order to function in the marketplace because the consumer expects to have that minimum amount of protection. If regulators and politicians wish to encourage competition from the small companies so that they continue to nip at the heels of the larger companies and bring innovations into the financial services industry, then you have to encourage them with the use of deposit insurance. Over the history of the financial services industry in the last twenty-five or thirty years, most of the innovations in financial services, particularly in the deposit area, have been started by smaller companies and then adopted by the larger companies. I think the small companies, though they have a tendency to get into trouble more frequently than the larger ones, are very necessary for ensuring that there is competition in the system.

PETER DEY: The issue comparable to the concerns about deposit insurance so far as securities regulators are concerned is protection for customers of securities firms who have free credit balances standing with securities brokers. There have been recent estimates that free credit balances exceed one billion dollars. Securities firms have entered into intense competition with deposit-taking institutions. They have attracted these funds into the securities firms, in the form of free credit balances, but in other forms as well, such as investments in mutual funds tailored to particular needs.

The securities industry and the self-regulatory organizations have established a national contingency fund that amounts to about $9 million. The fund is backed up by the convenants of the members of the self-regulatory organizations. Together with the convenants, the fund is intended to provide to customers of securities firms protection comparable to deposit insurance. But securities regulators in Canada have been examining this whole issue of client protection and there are a couple of issues that are of particular concern to the regulators.

The first one is simply coverage: is this fund plus the covenants of the members adequate? The second concern is the extent of the coverage. The coverage now extends to clients of members of the self-regulatory organizations, but there are a number of firms active in the securities industry that are not members of the self- regulatory organization. The third issue is the implications of the competition that I have referred to, the extent of the free credit balances and the rate of growth. Does this rate of growth balance the coverage of the fund and the covenants? The regulators have had a number of submissions made to them by the self-regulatory organizations, and I expect that they will be hearing more in this area. There may be requirements for increased disclosure imposed upon member firms as to coverage. There are some firms that are probably exploring, for competitive reasons, the provision of private insurance. They would arrange for insurance from a private insurer to be available to their clients who have funds on deposit with the firm. This is a very lively issue within the securities industry.

LARRY BELL: Universality indeed is an issue. Vancouver City Savings is about 15 per cent of the retail market in Vancouver and environs, yet we are excluded from having federal deposit insurance. Indeed, our own system of deposit insurance in the province has some $6 billion in assets. We insure ourselves through a joint guarantee, and the costs this year are roughly twice what CDIC premiums are. Mr MacIntosh made a prediction about maybe that not staying that way after the budget. There exists the equity and competitive issue of not having a federal guarantee.

I am persuaded that there ought to be some way in which we force managers and boards to internalize risk. I understand some of the complications – it may penalize market innovators, it may restrict

entry, we want to meet regional needs. But I think some form of penalty rates, perhaps as Dick Humphrys suggested, has a lot to offer.

Let me make a couple of other observations. First, in this whole area of regulatory matters we really have to think about the role of the external auditor and the whole question of generally accepted accounting principles. We all know that we find those principles convenient at times, and I think we really have to step up to this issue. Do our financial statements accurately reflect the financial strength of our institutions? Canadian financial institutions will probably face a rate increase and ought to have some concern about the quality of information and what it represents behind the balance sheet.

Second, what is the role of the auditor? What kind of timely disclosures should there be and to whom? To what degree should we have inspectors and auditors and our own internal auditors poring over our books? But what do we get? Well, we get tickers and checkers mostly, and those of you who have responsibilities as managers find that most of the matters that surface are those that one would consider to be important, but in the bigger picture trivial. We have to have some form of regulatory inspector who steps back from the issues and really looks at the strategic position, the fundamentals, and makes observations about, for example, regional and industrial concentration, the stability of the liabilities, underwriting policies based on a high inflation rate, and asset-and-liability match. When you get a fundamental look at those you really understand what kind of risk is involved in the institution.

We need a gradient of responses. It must not be just yes or no; you have to be able to move early and you have to have a gradient of responses in order to escalate and give an organization an opportunity to change and modify when concern is discovered. My last observation is that I would very much support – again Bob MacIntosh commented about it – some form of advisory board, some sort of input by the industry directly into the administration of deposit insurance. We all have some knowledge of what is going on with respect to our competitors and the industry, and I think that input would assist the regulatory process.

JACK CARR: One of the major proposals of the Green Paper was the creation of financial holding companies. There was some disagreement in the conference; some participants thought it would increase

competition, some thought it would decrease competition, some thought it would solve the self-dealing and conflict-of-interest problems, and some thought it would do nothing of the kind. I would like to throw this question out to the panel, the question of the Green Paper proposals and whether they would increase competitiveness in financial markets, and whether they would do anything for self-dealing and conflicts of interest.

GRANT REUBER: I think competition has become one of the buzz words whose meaning is frequently unclear. It has a very precise meaning: the absence of any control over the total supply of a good or service being provided to a market. The Green Paper presents no evidence that any such control exists in Canadian financial markets for any product or service that I am aware of. The basic premise that there is not enough competition or that somehow somebody is controlling the supply of products and services is by no means borne out by the facts. If you look at other data such as ease of entry, return on equity, and so on, it is not evident either.

Leaving that aside, I think the model of a financial holding company does not necessarily imply increased competition. There are two ways of looking at that: first, that the holding company could be so isolated that it has absolutely no connection with any other company in the family, in which case it is a stand-alone item anyway. While in principle that may be possible, as a practical matter, it is not likely to be the outcome.

The other, and I think more realistic, possibility is that there will in fact be self-dealing of one kind or another subject to certain rules. To the extent that that happens, the flow of funds will be internalized within the conglomerate family. I would argue on economic grounds that that is undesirable because it increases the likelihood of a misallocation of funds.

Perhaps even more important, the notion of adding a bank to a financial conglomerate, which itself may be part of a larger conglomerate that includes non-financial firms, and the pyramiding implicit in that model, impair the safety and soundness of the system. If and when such a pyramid runs into difficulty, the country will have enough problems without, at the same time, having confidence in the banking system undermined as well because a bank is a member of

the family. That danger is not adequately recognized in the Green Paper.

There are many other things one might say, but one of the difficulties in dismissing the proposals is that nobody is sure what the regulations will be at this stage. The financial holding company could mean very little or it could mean quite a lot. I think for example, it poses substantial complications from the standpoint of federal-provincial relations. The financial holding company has to be a federally chartered company. This could be interpreted as a shift in power between the federal and provicial governments. Moreover, it is possible that the provincial governments will extend the commercial lending powers of the provincially chartered trust companies. This could result in a shift of trust companies from federal to provincial charters to avoid the restrictions of the Bank Act. Rather than increasing federal control over banking, the result might then be quite different.

By putting a bank within a financial holding company that may be part of a larger conglomerate including non-financial firms, the potential for self-dealing and conflicts of interest is inevitably increased. To counteract this, it is proposed to set up greatly expanded regulatory machinery and regulations. But even if this government or the next sets up very tough rules and makes them work, there is no assurance whatever that all governments in future will do the same.

We have a system in Canada that, despite a number of difficulties, has worked effectively. Implicit in increased competition is the notion of increased risk. To the extent that competition becomes more intense, risks are increased. I think that this particular way of trying to increase competition could increase risks more than others. It may not increase competition as much as expected, and the benefits to the general public – particularly those sectors of greatest concern to governments – are open to serious questions.

EARL ORSER: Mr Chairman, you put forward the invitation to comment on the Green Paper. I wasn't sure what should be said at this conference, at this panel, until I saw this morning's *Globe and Mail.* When I read the reports of what was said yesterday, I felt that something important really needed to be said. I want to make a short statement now about the Green Paper. I think the Green Paper is an aggressive document that proposes structures and a system of regu-

lation and supervision for the financial service industry that are realistic and compatible with today's realities. I think that the principles articulated in the front of the Green Paper are proper.

I think we should remind ourselves – and this is not often discussed – that the process of developing the Green Paper included consultation with a panel of senior operating executives of financial institutions and a number of informed and independent people (the Dimma Committee). The process included the measurement of a number of proposals against the real expectations and demands of today's markets and also against the capacity of today's institutions.

Although the panel or the committee was organized and convened by the previous government, it was reconvened by the present minister of state and minister of finance, and I think that parts of the committee's work and conclusions are reflected in the Green Paper. The present minister of state and minister of finance and, particularly, the deputy minister of finance and senior officials are to be commended for carrying through that process. They have presented proposals covering all sectors of the financial services industry rather than trying to do a piece-work job which would have led to more uncertainty and confusion, and galloping legislative obsolescence.

The federal officials at these meetings asked for information and advice, paid close attention, and learned a lot. Probably the most important achievement of the committee's activity was that these officials got to understand how our industries really work, who the customers are, what markets are, and how we manage financial service institutions. I think most of the proposals in the Green Paper are realistic and practical. This is a rapidly changing, technology-intensive industry, and yesterday's Utopia may be today's reality. So the Green Paper was necessary, and of course lying at the bottom of it was the urgent need for change or updating of the trust and insurance industries legislation. I just want to make that general statement because I feel strongly that the paper is relevant.

The topic of this panel is short- and long-term prospects for change in the regulatory environment. The prospects for change are pretty good, because regulatory change is imperative and we can't live with what we've got today. The rate of change in the North American financial service industry is rapid. High interest rates and internationalization of markets, aggressive marketing management, the emergence of consumer and commercial financial services, and fast-

moving technology have produced great activity, progress, and challenge.

I am among other things, deputy chairman of the company called Trilon, which now has equity of $700 million and aggregate consolidated assets of $15 billion. Three years ago it did not exist, and that, I think, is an indication that things are changing.

If the Canadian financial industry is going to continue to fulfil its role, then the legislative and regulatory framework must catch up. Moreover, it must provide guidance to us in future development, and the risks of failing to adapt are simply too high.

With that I would just make a couple of comments on the matter of the financial holding company. I don't think it is illogical that it should be recognized and legitimized, and the constitution and activity of financial holding companies should be defined and controlled and regulated. I am not persuaded, as Mr Reuber apparently is, that permitting a Schedule C bank will impair the soundness of the system. Those of us who were on the committee would recognize a lot of the things in the Green Paper, but not the Schedule C banks, which certainly were news and quite a surprise. I disagree that the existence of a Schedule C bank will increase the potential for self-dealing. If one accepts the principles that are put forward in the Green Paper, including the need to define self-dealing explicitly and carefully and to minimize the prospect of harm coming from conflicts of interest, then I really cannot see a problem. As for whether it is logical for the Trilon organization to have a Schedule C bank, we are not sure of that yet, but it will depend on our attitude to commercial lending.

BRIAN O'MALLEY: While I was sitting chewing on my chicken at lunch, I had to wonder whether I should turn to Earl Orser and ask him if he wrote the Green Paper. It certainly ties into the needs of the major trust companies that are primarily part of what you would call a holding company structure now.

I think that the Green Paper does very little for the other hundred or so trust and loan companies that operate in Canada. In fact, I was mystified by the direction that the Green Paper took after the trust and insurance companies made their representations to the regulators. We were looking for a small expansion of our commerical lending activities as a means of recognizing that the banks had moved

into the trust companies' traditional turf and were competing quite heavily with us in mortgage-lending. We wanted a quid pro quo to help the trust companies to meet this competition, also as a recognition of the fact that the traditional mortgage markets are shrinking, as the demographics point out, and will continue to do so for the balance of the century.

The other thought that struck me was that this was really a means of moving control of provincially regulated companies into the hands of the federal regulators. I doubt that it was made to improve competition, except for a relatively small number of players in the business.

Another thing I began to speculate on was what Standard Trustco would do if we were permitted to apply for a Schedule C bank charter. Given the turn of events in Canada in the last few months, a company like ours, if we had all the rights of a Schedule A bank, operating as a Schedule C bank, probably would apply for a charter. The regulators have made it perfectly clear that banks have some kind of exalted position and are viewed in a different manner than trust companies or other types of financial institutions. I am sure this message has filtered down to the customer. He recognizes that the governor of the Bank of Canada and other regulators look on banks in a somewhat different light than they do trust companies, as is witnessed by comparing the fates of CCB and Pioneer Trust in Western Canada.

However, if they do allow us to have a Schedule C bank, I don't like the idea of being called a Schedule C bank, because at school somebody who has an A grade is somehow viewed differently from someone who has a C grade. It seems to me that if a trust company were to apply for a charter they should call us a Schedule A1 bank, in view of the quality of the assets of trust companies as opposed to banks.

PETER DEY: I would like to pick up a point that Mr O'Malley made about the regulation of the holding company. As I understand it, the Green Paper proposes two regulators. One would regulate conflicts of interest, and a super-regulator would oversee the activities of the holding company. It is imperative that there be some co-operative relationship between the federal regulator and the regulator of the financial institutions underneath the holding company. The Green Paper proposals would require a co-operative approach between the

federal government and the provinces, but there is the potential for an interesting conflict in jurisdiction, or competition for jurisdiction, between the regulators at the different levels. It is interesting that the Green Paper did not suggest establishing a federal securities regulator. There was absolute deference to the provinces.

I agree with the thrust of the Green Paper. I think that the approach used by those who defined the policy is correct, that there is not a burden to show that there is inadequate competition in commercial lending. The correct approach is to allow the free market to determine who provides the financial services and on what terms, and this approach should be subject only to overriding issues of public policy. I think one of the principal public policy concerns implicit in the paper is the concern about self-dealing. One approach to self-dealing is obviously to limit ownership to, say, 10 per cent. I think in this case there was obviously a balance between continuing the ownership restrictions on the one hand and facilitating ease of entry on the other. I agree with the way the balance was tilted in this case.

LARRY BELL: I was mystified by the Green Paper. It seemed to me that if competition was one of the goals then the question is not whether the trust companies should have the ability to enter into commercial lending; the question should be: why not? Credit unions have no legislative impediment to get into commercial lending and choose, for purposes of diversifying our portfolio, to get into it. Ed Neufeld brought us back to basics and said, look, it's the customers we're concerned about here. Our commercial lending is at an embryonic stage at this time, but we have had a lot of our members go back to their regular banks and have their rates reduced.

There is room for competition. New players have limited capacity to make any dramatic, bold moves that will disrupt the marketplace. So I say: why not?

One of the speakers talked about an international trend toward homogenization. In my last year with Vancouver City Savings, I have spent all my time trying to do just that. We have tax preparation, leasing, business leanding, insurance brokerage, and annuity brokerage. We are going to introduce financial planning in trust services, and we have leased space to a lawyer, an accountant, and a travel agent. From what we can determine, our membership is pleased. They want this convenience and they want to see these

services at one location. Their budget is a time budget; they want efficient use of their time.

Coming back to the Green Paper, if the holding companies exist and you can quite easily give commercial lending to trusts, then why the Schedule C bank? As I read it, the prohibition in self-dealing seems to take away most of the synergism. We ought to look for ways to capture that synergism through rules that seek disclosure and third-party review of intercorporate transfers and public offerings. We should emphasize disclosure rather than prohibition.

PETER DEY: I have a copy of the Royal Trustco information circular for its last annual meeting. To me, it reflects the concern of one financial institution that is part of a financial conglomerate with the issue of conflicts of interest. The proposal put before the shareholders was to establish a business conduct review committee of the board of directors. This was a committee of the board made up basically of directors disinterested or not affiliated with other companies within that conglomerate. The committee was to establish guidelines for determininig whether a proposed investment or loan, or other business activity, is significant and whether a conflict of interest relating to the proposal was material. Then there would be guidelines for dealing with situations that raised conflict-of-interest concerns.

JACK CARR: For the financial deposit-taking institutions, the discussion of deposit insurance and the federal Green Paper certainly impinge a lot on short- and long-term prospects for change, because changing regulation is certainly going to affect what is going to happen both in the short and the long run in various industries.

Before opening up to the audience, I want to give the panel a last chance to address the issue directly, and since we really have not looked at the investment industry at all, I want to add that there has been a lot happening in it with entry and ownership questions.

PETER DEY: There are four principal pressures on the investment industry that I became aware of when I was at the commission. These are the increasing importance of the exempt market; the emergence of the bought-deal environment; the competition among participants in the financial system for saver and investor dollars; and the internationalization of the capital markets.

The exempt market is important because it is an aspect of the capital markets where ownership restrictions are not applicable. To operate in the exempt market you do not need registration with the securities commission, which is the means by which ownership restrictions are imposed to reflect government policy. The increasing importance of the exempt market within the capital markets adds a competitive pressure to the conventional industry.

The bought deal is symbolic of some of the dramatic changes taking place within the corporate financing component of the capital markets. A process that used to take several weeks can now be collapsed into a matter of hours. This is putting a premium on capital and investment dealers who can accurately judge the markets.

The Green Line Investor Service is something that I spent a lot of time thinking about when I was at the commission. In many respects we were pleased to have the opportunity to think about it, because it required the regulator of that one pillar of the financial system to think about the key functions of the securities industry. We defined key functions as those functions within a segregated financial system for which there should be a regulatory structure that excluded other participants in the financial system.

Finally, the internationalization of capital markets is reflected in the willingness of all major Canadian issuers to check out all markets before raising funds. There have been a number of responses available to Canadian investment dealers to deal with this trend. We read yesterday in the newspaper about a Canadian securities firm that has acquired a US securities firm. There are other trends to internationalization. The commission has been pressed to ease its ownership restrictions to allow more substantial investment in investment dealers from multinational firms. This has been proposed as a means for some Canadian dealers to become more active in the international markets or to respond to the pressures for internationalizing the capital markets.

The OSC responded. We had a hearing last year, and a new model for regulating entry into the industry and investment in the industry was proposed. The Dupré Committee is studying or reviewing the commission model. Late last week the securities industry capital markets committee reacted with a fifteen-page broadside at the commission report, and it sustained its position as being really at one end

of the spectrum on possible models for regulating entry into the investment industry.

The commission's approach is the one I suggested earlier underlies the Green Paper: let the free market decide who participates in the capital markets, subject to overriding principles of public policy. The two principles that the commission was concerned with were that the securities industry be controlled by Canadians, and that, until dismantled, the commission model should recognize the existence of the four-pillar financial system in this country.

Where is it all going to end up? The commission, I understand, will be publishing draft regulations before the summer for comment. There will be a comment period during the summer, which presumably will give the government an opportunity to establish its priorities, but I expect that ordering of priorities will not occur until the government receives the report of the Dupré Committee, and I think this will move the whole process to the end of the year.

I think the delay in addressing commission recommendations, and the need for a minority or a coalition government to address what it may perceive as more pressing social and economic issues, may place the securities commission in a very awkward position. The commission has tons of discretion that is vested in it in order to deal with unforeseen situations, but with this discretion there is a price. I think it is inevitable that if the government does not respond to the commission's recommendations, then some time toward the latter part of this year, some registrant will go to the commission and seek relief from the ownership restrictions, in order to establish or implement some scheme that it perceives to be consistent with the public interest as articulated in the commission report.

The onus on the commission I think will be compounded if the government awaits the very sensible, but I think impractical, co-operative federal-provincial approach to reforming our financial system.

I think volatile times are ahead for regulating entry into and investment in the securities industry.

JACK CARR: Larry, is there anything else you want to say on short- and long-term prospects for change?

LARRY BELL: One of the observations I would like to make (and somebody earlier this morning made it in a much more refined way) is that regulations are a response to yesterday's problems. I am mindful of the experience I had when I had regulatory responsibility for Crown land in British Columbia. There happened to be a rather bad skiing accident, an avalanche. It was a slow news day, and the media really worked these guys over. They got the ball rolling and the industry eventually ended up in the minister's office. They wanted the minister to put a law in place, regulating helicopter skiing, defining snow conditions and weather conditions that would take the pressure off an operator and his pilot. People sat in a lodge and were paying $500 a day and were pressuring the helicopter pilot to get to the top of that mountain. Fortunately, the minister had a good deal of common sense, and he listened, he nodded, and he promptly told me to lose the file. If you ever had a group of self-reliant, independent mountain men, it was these five people who came into that office. As I look back on it, I find it incongruous. I always have that in the back of my mind when I think about regulation.

Looking forward, the other day I heard someone say money is information in motion. Technology is daily increasing its velocity. If I thought that this conference, which was exceedingly interesting, missed something, it was looking forward. One issue is the electronic networks. I would hope that the Interact Group that is put together with two thousand automated terminals – a phenomenal undertaking that is a private organization – will be allowed self-regulation and that there will be ease of entry. However, it has all the earmarks of a public utility. I hope that we can see these networks evolve without the public utility regulatory model.

The last comment that I would like to offer, Mr Chairman, is that along with many others in this room, I have attended years of federal-provincial meetings. I imagine there are hundreds of years of federal-provincial meetings in this room. As a result of that experience, I have no confidence that we are going to be able to get an agreement with ten provinces and the federal government for a series of bold strokes. It seems to me that what we need to do is get some sense of strategic direction that we all can agree on and then work on a series of small victories.

BRIAN O'MALLEY: I guess the one area I might comment on is what I see looking out into the future after reading the Green Paper. I see re-regulation of the financial services industry; and rather than the hoped-for cutting back on regulation, it would appear to me there is going to be some significant increase in the amount of regulation and the numbers of regulators and auditors and inspectors who will be rooting around in the various financial companies, seeking the ghost of Lenny Rosenberg. I have doubts that they are going to be very successful. My vice-president of finance said to me, 'The law cannot stop a crook; the clerk becomes a crook, and then the law catches him afterwards.'

I get concerned that we are going to put an awful lot more power into the hands of the regulators and emasculate the managers who, as Mr Orser has pointed out, deal with questions of conflict of interest and self-dealing every day in the normal course of business. I think the reputation on the record of most businesses has been awfully good in dealing with those questions. Rather than increasing the number of rules and regulators and hiring a lot more inspectors, as I foresee from the implications of the Green Paper, I think that the Canadian consumer will be much better served to look for more self-regulation from the industry itself.

In the trust company industry for instance, some kind of advisory council representing members and chief executive officers of the various financial institutions, to consult with the regulators, would make a lot of sense, because the shady operators are known to those people who are in the business long before the news gets to the regulators. In the trust company industry, for example, most trust company managers who followed what was going on in the business knew what was happening in Greymac and Seaway at least a year, maybe more, before the regulators stepped in. I think that the Canadian consumer might be much better served and much more economically served if there was communication among those who are daily active in the business and see what is going on and see the kind of activities that some companies are engaging in, and feel compelled by virtue of this self-regulation to inform the minister, or inform his representatives.

QUESTION: I am interested that you often repeated a remark that conflicts of interest are frequent in businesses and you deal with them

every day. That implies that some of these conflicts of interest are quite appropriately resolved internally. Your boards of directors and whoever has the responsibility can handle these conflicts. Some conflicts of interest are not of that kind; however, there is a public interest in restraining such kinds of self-dealing. Which kinds are appropriate for some public scrutiny and which ones are not? What principles are there? What will determine whether a conflict of interest is best dealt with by a regulator or best dealt with internally? Do you have any comments in that respect?

BRIAN O'MALLEY: I do not have a ready answer to that question as to how you divide up those conflicts that should be handled by regulators and those that should be handled by managers. The regulators, I guess, are there to make sure that management acts in the best interests of the consumer or the customer, as well as the shareholder. I suppose the regulator should step in when it becomes evident that the managers are not meeting the tests of conflicts of interest in the interests of the customer, who in the end has to be foremost.

JACK CARR: There is an interaction between conflicts of interest and deposit insurance. When you have deposit insurance, depositors are not worried about potential conflicts of interest in the financial institution. Thus, there are not those disincentives for the institution itself to worry as much as it otherwise would about conflicts of interest, and so you do have them in the market all the time. You never have it taken care of perfectly. But deposit insurance definitely exacerbates the problem of conflicts.

PETER DEY: I was going to say that the investment industry has considerable experience in dealing with conflicts of interest. For example, our regulatory system recognizes that investment banking and commercial banking services should not be available from one source. This would result in a conflict of interest that I think people feel cannot be justified. The public would not accept it. Another conflict of interest arises when a firm agrees to underwrite a security. It has the interest in marketing a security, but also in making its investors happy. But this is a conflict of interest that is disclosed, and the public is prepared to accept it.

The other type of unacceptable conflict of interest is between investment and commercial banking. I doubt that you could convince the public that its interest was really being protected unless you had that segregation between investment and commercial banking.

BRIAN O'MALLEY: My father always told me there are two basic motivators – fear and greed. Because the regulations and legislation governing trust companies are so far out of date that they do not cover the many possibilities for self-dealing and other problems that have come up, greed gets into the ascendancy. Our penalties are not effective enough to punish operators of trust companies who see an opportunity to self-deal. There is a real need for strong penalties.

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ISSN 0-225-591X ISBN 0-7729-0956-3